Monetary Policy and Operations of the Reserve Bank of India 1935 — 1961

DISSERTATION

for the Acquirement of the Degree of

DOCTOR OF PHILOSOPHY

submitted

to the Faculty of Philosophy and History of the University of Basel

by

NUR ALAM MOLLAH

of Calcutta/India

1966

Die Reprografie - Stuttgart 1967

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Accepted by the Faculty of Philosophy and History of Basel University on the recommendation of Prof. Dr. E. Salin and Prof. Dr. G. Bombach

Basel, February 11, 1966

Prof. Dr. Heinz Rupp

Dean

UNIV. LEIDEN BIBL.

P R E F A C E

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This thesis, as the title implies, is an attempt to evaluate the monetary policy and operations of the Reserve Bank of India. The period covered in this study extends from the inauguration of the Reserve Bank in April 1935 till the end of the Second Five-Year Plan.

The main body of the thesis is preceeded by an analysis of the role of the monetary policy in an underdeveloped country like India, and by a detailed description of the Indian monetary system and institutional arrangements which form the basis from which a central bank can operate to make its policy effective. I have then traced the slow evolution of central banking in India and described the constitutional framework within which the Reserve Bank of India was originally set into operation. The first three chapters, which form the background, put the central theme of the study in proper perspective.

The purpose of the thesis is to examine critically the monetary policy and operations of the Reserve Bank of India for the first twentyfive years of its existence. During this long span of years the Indian economy passed through the painful process of recovering from the Great Depression to the highly inflationary situation during the Second World War, and then through the post-war difficulties to planned development of the economy under the successive Five-Year Plans. Each of these phases has been delt with separately, where an examination of the economic condition and monetary policies are followed by the analysis of the operations of the Reserve Bank and their effectiveness.

This study has been prepared as a doctoral dissertation at the University of Basel, Switzerland, under the personal supervision of Prof. Dr. Edgar Salin. Towards the end of my research work Prof. Salin suggested that I should extend my study to include the problems of rural credit in India. This is such a vast and complicated subject that it needs a separate study and to incorporate the problems of rural credit in the present work would have meant a complete reorientation of the contents and structure of my dissertation. Not only that, but difficulties of obtaining materials from here, lack of time and finance - all these prevented me from following his suggestion.

I would like to express my sincere gratitude to Prof. E. Salin, who has been a constant source of inspiration, advice and encouragement. I would like to express my thanks to Prof. Dr. G. Bombach and to Prof. Dr. K.W. Kapp for their comments. My thanks are also due to Prof. Dr. H.W. Zimmermann, Director of the list Institute for allowing me to use the facilities of the institute.

Materials of this study were collected partly from the India House Library in London during my stay in England in Summer of 1963, partly form the Indian Embassy in Berne, but mainly from the library of the Bank for International Settlements in Basel. Regarding the last mentioned source, I would like to express my sincere thanks for the help and courtesy that were extended to me by the Bank.

Last but not least, I would like to extend my thanks to the Basel Stadt Stipendium Kommission and to the University authorities for their financial assistance, without which it would have been impossible to undertake this research study.

N.A. Mollah

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N O T E

The expression lakh and crore signify
100,000 and 10,000,000
respectively

CHAPTER I

INTRODUCTION

The determination of the role of monetary policy for underdeveloped countries has been difficult and complicated by the lack of a general theory for such economies. Economic theory has not so far concerned itself with the development problems of underdeveloped regions of the world. [1] The Classical and the Keynesian theories are rationalisation of the dominant interests in the industrialised countries where it was put forward and later developed to deal with the phenomenon of income fluctuations in those advanced economies. But the main characteristics of underdeveloped economies [2] are different from the postulates of Keynes and his predecessors. There may be a lot of truth in those theories and one or the other may satisfactorily explain some of the current features of underdeveloped economies but a mechanical application of any of the existing theory, however tempting, is full of short-comings and a deliberately planned rapid change will outdate any prevailing rationale which does not fit into new conditions. We shall, therefore, study here the major problems of an underdeveloped country like India and consider the course of monetary policy for such an economy as a special case.

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[1] Most of the literature on development problems on underdeveloped countries are, on the whole, non theoretical - some sort of analytical economic history. There has not emerged any general theory for such economies which, of necessity, must be comprehensive enough to take into consideration all the diversified and complex economic and socio-economic factors. G. Myrdal. Economic Theory and Underdeveloped Regions, 1957, PP. 98 - 104.

[2] H. Leibenstein. Economic Backwardness and Economic Growth, 1957, PP. 40 - 41

THE BASIC PROBLEM OF AN UNDERDEVELOPED ECONOMY

Most of the underdeveloped countries, under normal circumstances, are suffering from some sort of "long-term underemployment equilibrium". The term equilibrium is a misnomer here because what really persist are small variations in their extremely low level of income, employment and capital formation all moving in a vicious circle [3] -- acting and inter-acting on each other both as cause and effect. The problem, therefore, is two-fold : firstly, breaking the formidable vicious circle of poverty and secondly, leading the economy from very low income to a high level of income and employment. The crux of the problem is not only to prevent stagnation but to break through it by means of deliberately planned and dynamic growth of these economies, for there is no dogma of automatic adjustment as an answer to economic stagnation. [4]

The starting point for all plans of economic development of underdeveloped countries is to break the hard ring of poverty at the point of low capital formation or investment, because the rate of potential increase in income, i.e., the rate of development is a function of income saved and invested and of the coefficient of productivity. [5] In underdeveloped countries an increase in productivity tends to exert downward pressure on price level rather than increase in income owing to the lack of new and sufficient investment opportunities.

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[3] R. Nurkse, Problems of Capital Formation in Underdeveloped Countries, 1953, P.5., R.R. Nelson, "A Theory of Low-level Equilibrium Trap", American Economic Review, December 1956.

[4] A. H. Hansen, The American Economy, 1957, P. 23.

[5] F. Pagos, "Economic Development and Financial Stability", I.M.F. Staff Papers, November 1952.

The existence of a large volume of disguised unemployment -- another important phenomenon in underdeveloped countries -- is due to the lack of complementary capital and technical resources. An added function of investment in underdeveloped countries besides income-generating and capacity-creating, is that of a "pace-setter for additional investment".[6]

In most underdeveloped countries the rate of investment is very low, something like 5 %, and in many cases, with high population barriers, it is even less than that. Such a rate of investment is well below the critical or minimum level to act as a stimulant necessary for escaping from low-level equilibrium trap and stagnation. This point has been putforward with dramatic force by Rostow in his theory of "take-off level" at which the economy will have a self-sustained growth.[7] Rosenstein-Rodan's theory of "big-push" [8] and Leibenstein's "critical minimum effort" thesis [9] run along the same lines. Basically, all these theories center round one point, that is, unless the net investment reaches a certain definite level -- say from 10 to 15 % -- an underdeveloped economy has a tendancy to remain within the vicious circle of poverty and underdevelopment.

MONETARY POLICY AND INVESTMENT

The Keynesian investment function is directly based on the schedule of marginal efficiency of capital in relation to the rate of interest ;

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[6] A.O. Hirschman, The Strategy of Economic Growth, 1958, P. 41. A.H. Hanson, Public Enterprise and Economic Development, 1959 PP. 136-7.

[7] "Take-off into Self-sustained Growth", economic Journal, March 1956 Stages of Economic Growth, 1960, Chapter 4.

[8] "Notes on the Theory of Big Push", a paper submittet to the Rio Round Table of the International Economic Association, 1958

9 Economic Backwardness and Economic Growth, 1957, Chapter 8

savings and investment are equated through changes in income and expenditure, savings always being the camp follower. The Classical investment function is based on the Fisherian concept of the rate of return on capital (which is nearly the same as Keynesian marginal efficiency of capital) in relation to the rate of interest, savings and investment equality is achieved by the rate of interest, savings being an active factor. The number of variables are nearly the same, if income is taken as given, But there are sharp and big differences as to the determination and behaviour of the variables like the rate of interest, marginal efficiency of capital and savings. [10] There are also other differences between the position taken up by Keynes and the Classical economists, and it hardly helps to discusss them in the abstract. Here we shall discuss only the relevant ones in relation to the nature of the investment function in an underdeveloped country like India.

For the last one hundred and fifty years investment has been low in India, and for this blame is often placed at the door of the colonial rulers. It is true that the British rulers of India did not encourage investment and economic development of the country. But it is doubtful whether India would have been a modern and industrialised country had there been no alien rule. Because the main factors responsible for the present day economic backwardness of India could be traced to the socio-economic structure and cultural background of the country. Outmoded institutions and sense of values, unhealthy group and caste relationship, and lack of initiative and enterprise -- all these are resistant to any self-propelling large-scale attempts at investment.

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[10] J.M. Keynes, General Theory of Employment, Interest and Money, 1936

Irving Fisher, Theory of Interest, 1930.

The chief problem of investment and economic development of India is to reorganise the Indian sense of values, attitudes and institutions. Economists and sociologists are now increasingly emphasising the necessity of social and institutional reforms as conditions of economic progress. Nothing more can be said here on these as these are outside the scope of the present study. While efforts should be directed towards the reorientation of the existing social structure of India and attitudes of her people a deliberately engineered large-scale investment and economic development would break through these social barriers and accelerate the transformation of a backward and stagnant economy into a progressive, self-sustaining and self-generating economy.

Investment is low in India partly because savings available for investment are low. Total savings of the community are not canalised into the organised market for investment ; only a part comes to this market. Saving and investment equality conceals this problem. The experience of the last few decades shows that in the absence of planned effort and proper envoirnment periods of large savings did not lead to any marked improvement in investment, savings ultimately declined to the old level. This is due to absence of organised financial institutions through which savings of the society could be collected. Whatever current savings are there will have to be collected, but the main emphasis should be on the marginal rate of savings, that is, savings from additional income brought about by investment. It is this "potential savings" as against current surplus which are more important in the context of underdeveloped countries. The existence of large savings alone does not guarantee a higher level of investment. This might appear like the Keynesian reversal of Say's law.[11]

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[11] J.D. Sethi, Problems of Monetary Policy in an Underdeveloped Country. 1961, p. 91

But the situation is much more than that, because the reversal of Say's law was based upon the role of effective demand which assumed a given large stock of capital goods, Unfortunately, the underdeveloped countries do not even have a large stock of capital goods. The position is nearer to Professor Marshall who advocated investment which would create both savings and investment. [12]

What about the factors determining the marginal efficiency of capital and its behaviour ? The Marginal efficiency of capital is a ratio of two factors : the expected future return on investment and the cost of investment. In an underdeveloped country like India, with small existing capital stock, the marginal efficiency of capital can be reasonably expected to be high.

But the marginal efficiency of capital is related to the future and the inducement of a high marginal efficiency of capital can be reduced considerably by a high discounting of it by uncertainty and risk of the future, Uncertainty and risk factors are in profusion in India and holding back economic progress, A large number of failures of companies and individual enterprises are quite common. Uncertain import policies and uncertain purchases abroad create real difficulties for most of the equipment needed depends on timely imports. There is also keen competition from foreign manufacturers, and the smallness of the market is another deterrent.

12"With the growth of openings from investment of capital there is a constant increase in that surplus of production over the necessaries of like, which give the power to save... Every increase in the art of production in the capital accumulation to assist and support future production, increase the surplus out of which more wealth could be accumulated" Principles, P. 224

One sign of this is the existence of large surplus capacity in certain industries even under conditions of inflation.[13] It reflects not only the imbalance on the structure of industries, but also shows that new industries do not provide the necessary corrective, An underdeveloped, disorganised and highly speculative capital market adds another factor of uncertainty.[14]

The unhealthy character of our capital market is not a thing in itself but closely connected with the nature and type of our industrial set-up. The existing position is that most industries are organised either in very small units or in large oligopolistic and monopolistic undertakings with managing agency system as their financial and administrative controller. [15] This leaves little scope for the expansion of medium-sized industries which are most naturally suited to the present stage of economic development. Further, the industrial system is throughly dominated by consumer goods industries and the setting-up of a big unit forces out several other smaller units from business, and this restricts the market as well. Also, with a managing agency system in control of financial institutions,the medium-sized entrepreneurs are at a serious disadvantage. All these factors create unequal and uncertain competitive conditions for investors. This weakness has been further enhanced by the presence of large foreign investments organised in big units, for they are honest, efficient and have greater technical superiority, and to successfully compete with them under unequal conditions, Indian industrialists are forced to resort to dishonest practices. Indian agriculture is subject to the "gamble of monsoon" and ever greater uncertainties ; consequently, the risk factor is more formidable.

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[13] Textile, paints, soap etc. are notorious examples.

[14] P.J. Thomas, Report on the Regulation of the Stock Market in India, 1948
V.R. Cirvante, The Indian Capital Market, 1956

[15] M.M. Mehta, Combination Movement in Indian Industries, 1952
D.R. Samant and M.A. Mulky, Organisation and Finance of Industries in India.

Thus even if we assume a high marginal efficiency of capital, a high discount factor of risk will militate against investment. Now, the marginal efficiency of capital is to be related to interest rates. In India, the structure of interest rates stands at a high level and most rates are institutionally determined, which cannot be readily subjected to changes in monetary policy. This is also another obstacle to investment. Again, agriculture is the most dominant and risky sector of an underdeveloped economy and returns on capital investment tends to materialise slowly : but a high interest rate is a deterrent to sinking funds in that sector. Above all, large and sudden fluctuations in agricultural prices by increasing the risk reduce the use of the interest rate.

The foregoing analysis is based on the assumption that the investment function is either Keynesian or Classical as defined at the beginning of this section. Even if we assume a high marginal efficiency of capital, low interest rates and a low discount factor of risk, investment may not increase because of the existence of real bottle-necks, some of which are in themselves responsible for both the high discount factor and the high interest rates. In addition there are several other real factors responsible for low investment as given below :

1) lack of entrepreneurs : Schumpeter's "dashing entreprenure" is a legendary figure ;[16]
2) lack of investment opportunities : there is marked absence of Keynesian secondary or Myrdal's spread effects ;
3) Uncertainty and costliness of capital equipment due to dependance on imports ;
4) difficulty of channelling existing or potentially existing domestic savings into available productive investment ;
5) uncertainty and inadequacy of foreign assistance ;
6) lack of vertically integrated industrial structure ;
7) insufficiency of decision making and managerial ability ;

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16 H.C. Wallich, quoted by A.Borne, Studies in Economic development, 1957, P. 249

8) lack of technical know-how ;
9) bottle-necks created occasionally by difficulties of transport and scarce raw-material,

It is a formidable list of real factors which none of the existing theories on investment can take into account. These facts are also responsible for the working of the investment-multiplier more in money terms than in real terms in underdeveloped countries and also for making aggregate output inelastic. [17] It may be said that the investment function is indeterminate or it would be practical and realistic to emphasise Lerner's thesis that investment is after all a political decision. This is more true today of underdeveloped countries which are embarking upon their economic development. What they need is pre-investment-investment, i.e. investment to remove these stumbling blocks. This is comparable to Rostow's pre-conditions for "take-off" for which not only the level of investment but also its pattern will have to be subject to political and social decisions taken seperately and apart from the market and its forces.

SAVINGS

At some point in the vicious circle in which an underdeveloped economy moves, we find that surplus or savings for new investment are small, which, of course, is given by low incomes. It is this low level of incomes and not the level of interest rate, which explains low savings because India has extremely high interest rates combined with poor savings. This is despite the existence of great disparaties of income and wealth, which are often justified on the ground that the greater the incomes, the larger would be the savings.

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[17] V.K.R.V. Rao, "Investment, Income and Multiplier in an Underdeveloped Economy". India Economic Review, February, 1952

The existence of these disparaties is true of all underdeveloped countries. [18] Further, it is also true of low incomes that a higher interest rate would cause less savings because people with low incomes will save what is absolutely necessary, and with higher interest rates a given income can be derived with small savings.

It is reasonalbe to assume that the higher the income of an individual, the larger may be his savings ;but this is not necessarily valid for the community as a whole. [19] For example, the lower incomes may be so low as to cause dissavings which may be met by those who have saved. Another fact which conspires against a higher social marginal rate of savings in India is that higher incomes are often concentrated in non-entrepreneural hands. The attitudes and values of these people are similar to those which were fiercely attacked by Adam Smith. [20] Most of their incomes are dissipated in conspicuons expenditure like ceremonies, buying jewellery, investment in land and real estate, speculative transactions, particularly gold. Further, current savings also depends upon the backlog of demand which has become chronic with the vast masses having had a low standard of living for generations. Under such circumstances, the inequalities of incomes as such cannot reduce the marginal of average propensity to consume. If the the vast majority of people have an extremely low level of income, the rate of discount of the future against the present - an integral part of the neo-classical theory - will be high, and may even be higher than the current rate of interest.

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[18] T. Morgan, "Distribution of Income in Ceylon, Puerto Rico, the United States and the United Kingdom", Economic Journal, December 1953 ;
I.B.R.D. Mission Report, Economic Development of Nicaragua, B.Datta, Economics of Industrialisation, 1952; H.G.Aubrey, "Investment Decision in Underdeveloped countries", in Capital Formation and Economic Growth, 1955.

[19] G.Haberler, "Interest Rate and Capital Formation" in Capital Formation, National Industries Conference Board, 1939.

[20] H.A.Marquand, "Characteristics of Economic Development" in Lectures on Economic Development, International Inst. for Labour Studie 1962

The only point is that the assumption is not valid for developed economies ; but for underdeveloped economies, it is more than obvious and in this case the interest-elasticity of savings becomes too thin. We are nearer to Keynes in believing that there is no functional relationship between savings and interest rate.

For low incomes, the curve representing consumption function has low elasticity, which means a high income elasticity of demand for expenditure. It was witnessed in India during the forties and early fifties that for a large majority of the population in rural areas the marginal changes in money incomes were followed by greater marginal money expenditure, taking into account the effects of changes in incomes as well as prices. [21] This means that low savings are due not only to the low absolute level of income but also to higher marginal propensity to consume. Duesenbery's "demonstration effect" also adds fuel to the fire. The central problem is that of raising the marginal savings ratio, which available income cannot secure. It appears that savings are going to be as much a political decision as investment.

A new version of the classical theory has been given in support of the interest-elasticity of savings, namely, the changing capital values affect consumption and thereby savings.[22] A fall in interest rates causes a rise in capital value and that in turn, it is argued, increases consumption. Now, it is true that for the rate of interest to be effective, either investment should be sensitive to interest or savings should be

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[21] S.A. Shah, "Science and Society" Winter 1959

[22] M. Friedman, Studies in the Quantity Theroy of Money, 1956
R.A. Musgrave, Money, Liquidity and Valuation of Assets"in Money, Trade and Economic Growth 1951

elastic to capital values. Working of both or either of the elasticities will do the job. But the former elasticity is not meaningful in underdeveloped countries as discussed earlier and as to the latter, interest changes affect bond prices but the bond market being so small in an underdeveloped country, it can be assumed to have only very negligible effect. Regarding other capital values like those or real estate, they change more in relation to general price level than to interest rates. The Indian experience of the last two decades shows continuosly rising curve of capital values irrespective of changes in interest rates. It has been noticed more often than not that both capital values and interest rates move upward under the strong pressure of upward price movements, In any case, the real estate owners have, somewhat naturally, a low propensity to save.

It is not the interest-elasticity but the other two elasticities, namely, the income and price elasticity of savings that are more significant. Actually, price-elasticity may have such a strong influence as to negate the effects of interest and even of income elasticity. The basic facts of the situation, that is, low incomes, large fluctuations in commodity prices, the dominance of basic necessaries like food and clothing in family budgets are to be kept in mind. It has been noticed in India that in times of rise in prices the rate of savings of certain sections of population decline and still worse, in certain other cases dis-savings may take place. This will be obvious if the price-elasticity of demand for expenditure on food is less than unity, and particularly so if it is nearer to zero than unity. Thus, if the working of the various elasticities is as what we have analysed here, monetary policy, particularly interest rates, is of little significance in pushing up savings of the society. One can say that price stability would be more conducive to higher savings, but then the relation between money and prices in India is such as to give little hope for price-stability being achieved through monetary policy.

Apart from the working of various elasticities, there exists in India a serious problem of a large flow of savings of a given period not fully being materialised into investment by the end of that period. It has been estimated by the Rural Banking Enquiry Committee that savings in the rural sector of India are about 1o %, a substantial portion of which is more in driblets and cannot be either utilised for direct investment or canalised through financial institutions just because of the absence of the latter.[23] This deficiency of channellising savings into private investment not only remains one of the most outstanding feature of capital formation in underdeveloped countries, but is also one of the factors of built-in-underdevelopment. [24] Here we have the opposite of forced-savings, i.e. savings without the facilities to transform them into investment. As F. Knight has pointed out the elasticity of savings is one theory and the elasticity of the supply of capital another. [25] If savings are kept under the mattress they do not help investment, nor if they are utilised in hoarding gold, a phenomenon quite common in India. These unspent and unutilised savings, however may provide a cushion against budgetary deficits planned through deficit financing. But there is a danger in such an assumption for in an inflationary situation when real incomes do not rise or rise slowly, these hoarded savings are likely to be spent and thereby intensity the inflationary pressure.[26] Yet the importance of these savings cannot be ignored because in the unorganised sector some of these savings are done by people who do their own investment. Any fall in this saving-induced investment would cause an equivalent reduction in investment. [27]

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[23] Rural Banking Enquiry Committee Report, 1950 PP. 37-39

[24] H.G.Aubrey, "Investment Decision in Underdeveloped Countries" in Capital Formation and Economic Growth, P. 429;A.O. Hirschaann. op. cit. P. 36

[25] "Prof. Fisher's Interest Theory", Journal of Political Economy, April 1937

[26] F.Benham,"Deficit Financing in Asia", Lloyds Bank Review, January 1955;E.M.Bernstein and J.G.Patel "Inflation in Relation to Economic Development".J.M.F. Staff Papers Nov 1952

[27] cf. The Report of Fund Mission to the Government of India.

From our discussion it can be concluded that savings for investment can increase when there exist the following conditions :

a) a rise in real incomes
b) stable price level
c) financial institutions for collecting national savings
d) investment opportunities for small savers.

Now, with the exception of c) and d) monetary policy is of little value regarding other determinants of savings.

There are certain conclusions which logically follow from our preceeding analysis. These are : firstly, any increase in savings will have to depend primarily upon the level of investment and incomes and the organisational effect to secure maximum share out of additional income. Profit oriented savings is an illusion. These efforts will have to be backed by deliberate institutionalisation of savings,.Secondly, left to itself the possibility of raising chronically low investment to a higher level through the working of existing social machinery and institution and by providing some incentives is a hopeless task. There exists no automatic mechanism to break through the vicious circle of underdevelopment. It is precisely for this reason that the current approach in most underdeveloped countries regarding economic development is not content with only stimulating private (induced) investment but places great emphasis on public (autonomous) investment, which alone can accomplish the task of pre-investment investment. Profit oriented investment is as frustrating as its savings counterpart. Marginal investment from dividends is hardly more than 20 per cent, and even less in many underdeveloped countries. Moreover,

profit-inflation may distort investment through the Ricardo effect [23] and the working of assets preferences. Finally, it has been shown that in early European industrialisation profits were not a major stimulus as is commonly believed. Wages lagged behind prices but the chief gain was not to industry but to agriculture through a relatively higher price for raw materials. For industry, inflation appeared more as cost than as profit inflation, [29] Hence the current emphasis is on public investment to reach the critical level.

The emphasis on planning and public investment is supported by several wellknown facts of experience [30] such as :

1) private enterprise and induced investments are ill-suited and inadequate for a big push towards take-off ;
2) public investment alone can fill the gap in the industrial structure disregarding the cost in the short period ;
3) basic industries and large multipurpose projects, which private enterprises will not undertake to start even in the most favourable circumstances,can be taken up by public investment ;
4) overhead costs like those incurred in providing railways, roads, electricity services which provide ground for economies of scale, are increasingly becoming the function of public investment almost everywhere ;

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[28] In a country like India where dominant characters of capital is short-run trading, capital costly, labour cheap, consumption goods, industries dominate (i.e. production in general is less roundabout) and price fluctuations are large, investment decision is bound to be subject to Ricardo's effect, unless controlled by planning.
F.A. Hayek, Profit, Interest and Investment 1939, PP. 9-10

[29] F. David "Profit Inflation and Industrial Growth, Quarterly Journal of Economies, August 1956.

[30] Arthur W.Lewis, Principles of Economic Planning, 1959, Introduction and Chapter I;Rosenstein-Rodar "Problems of Industrialisation of Eastern and South Eastern Europe" Economic Journal 1943;Scitovsky "Two concept of External Economies" Journal of Political Economy, April 1954;Government of India, First Five Year Plan 1952.

5) institutionalisation of savings and their canalisation into productive purposes;
6) public investment will not only raise the size of "surplus" but also set a pattern of investment consistent with social priorities;
7) elements of risk and uncertainty reduced.

Thirdly, whatever be the course of monetary policy and under whatever circumstances, if investment is discouraged the policy is not worth while. The use of monetary policy is relevant only during inflation, for during depression it has been found to be worse than useless. During inflation it operates through weakening the pressure of investment. Since the basis of the study of monetary policy for an underdeveloped economy exists only in the dynamic setting of growth, it is unrealistic to visualise a situation of growth without strains. Now, this strain on the economy cannot be relieved by reversing the process of investment, because that would amount to going back to the vicious circle from where we started. The strains may become stronger for there exists in the system some sort of a built-in-tendency towards a rise in prices. But to think of development without strains and to have only minimum unavoidable hardship without physical control on production, distribution and prices is simply wishful thinking. In an inflationary situation it is common to blame investment as the strains get heavier; this is, particularly so when the control system are introduced half-heartedly and ineffective. Yet investment cannot and should not be reserved. It may appear paradoxical, but it is the truth that to relieve the strain on the economy caused by planned investment, more investment and not less investment is needed. To quote G.D.Birta, "Often we adopt measures which are suitable to industrially advanced countries where over-employment and over-investment threaten to undermine the stability of their economy. In an underdeveloped country with plenty of idle labour and underused resources, there cannot be such a thing as over-investment or inflation arising therefrom so long as investment are directed towards productive purposes. There may be a rise in prices due

to shortage of goods, as has happened in respect of food grains, but such "scarcity inflation" can be met only by greater production." [31]

MONETARY POLICY AND CENTRAL BANKING

What then is the role of monetary policy in an underdeveloped country ?
Monetary policy which operates through the central banking mechanism can be taken to function in the following directions :

a) to maintain relative stability consistent with the growth of the economy ;
b) to control undue expansion of credit which may endanger economic stability and to make provision of proper credit for the growing economy and channel such credits to users in accordance with pre-planned investment ;
c) to establish and look after the working and expansion of financial institutions.

Before going into the details of these objectives of monetary policy, it is necessary to dispel some of the misconceptions center around the question of central banking and economic development of underdeveloped countries. In underdeveloped countries, there is a deep-seated tendency in people with zeal for rapid economic development to overemphasise the role of central banking and monetary policy. They look upon a central bank as an agency for bringing an era of low interest rates and rapid development of the resources of the country. In many of these countries, central banking is something new and all they know about it is its monopoly of note-issue. By a sequence of thought it is not surprising that they should reach the same conclusion as the nineteenth century directors of the Bank of England that the role of a central bank is to meet the letitimate needs of trade, in this case legitimate needs of economic development, irrespective of the volume of

[31] Chairman's Speech, United Commercial Bank 1959

demand placed upon it. [32]

However, such a misconception regarding the role of central banking is not confined to the man in the street, but there are economists who have suggested direct financing of industrial development by the central bank. [33] In most of the underdeveloped countries incomes are not rising as fast as the expectations of the community ; personal savings are low so that only limited resources are released for the expansion of capital and the tax system, after meeting government expenses, leaves a very small surplus available to finance development. Under such circumstances, if a government can persuade the central bank to create money to finance development projects, the problem of expanding the community's real assets may appear to be easily solved. Consequently, it is sometimes argued that "a case could be made for making inflation an instrument of (development) policy, rather than the control of inflation an object of policy." [34]

There is no doubt that money can introduce an orderly and regular expansion of the economy if other conditions are present. Money is related to growth in a permissive rather than a casual sense and it is a condition which should be present if growth potentialities are to be realised and sustained. [35] A smaller increase in money supply will retard growth of possibly cause contraction. In these underdeveloped countries the increase in the supply of money will not have to be proportio-

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[32] "Central Banks are institutions of considerable potentialities both for good and evil. In inexperienced hands they can easily promote inflation." W.T.Newlyn and D.C.Rowan. Money and Banking in Colonial Africa, 1954 P.220. S.N.Sen, Central Banking in Underdeveloped Money Markets 1952 P.233

[33] H.C.Wallich, Monetary Problems of an Export Economy-The Cuban Experience 1914 - 1947,1950 P. 295

[34] H.J.Bruton, Inflation in a Growing Economy P.57. Quoted and parenthesis added by G.S.Dorrance "The Effects of Inflation on Economic Development" J.M.F.Staff Papers, March 1963

[35] C.R.Whittlesey "Relation of Money to Economic Growth" American Economic Review, 1956.

nate to increase in production but somewhat more than that depending upon several factors such as monetization of the economy, shift in production and/or prices between agriculture and industry. A monetary expansion somewhat greater than current real output will introduce an element of flexibility in the economy and lead somewhat forced savings thus releasing resources for development. However, there are strict limits [36] to the amount of development which could be financed this way ; and any large expansion of the money supply will lead to inflation and to familiar and disastrous confusion between the ability to create money and the ability to create capital goods by a community.

Regarding the extraction of forced savings and investment through inflation, there is considerable literature [37] indicating the disadvantage of such policy. Even "controlled inflation", which is advocated, may have grave consequences for an underdeveloped country. These consequences need only be recalled here :

a) the misdirection of savings into foreign assets;into real estate and investories instead of industry and agriculture.
b) the shift in the distribution of real income is favour of profits
c) the pressure on the balance of payments and the possibility of currency depreciation.

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[36] It is difficult to give precise numerical figure as to the degree of inflation which will be conducive development. Even Prof. Bronfenbrenner's concept of "Optimum degree of inflation" does not indicate where is this optimum reached." The high Cost of Economic Development", Land Economics, August 1953
In any case the optimum degree or limit are low in most underdeveloped countries because of the inelasticity of production in the short run. The question is complicated and it should be answered by each government in terms of the situation faced in each country. B.Higgins, Economic Development 1959, P. 466

[37] See, for example, Nurske, op.cit.PP53-65, United Nations, Measures for Economic Development of Underdeveloped Countries, 1951, Chapter VI.A.W.Lewis,pp.cot.PP.222-226; G.M.Meier, "The Problems of Limited Economic Development", Economica Internazionale Vol.VI, No4,1953.

d) the ever-greater divergencies between private marginal product and social marginal product ;
e) the loss in consumption by some multiple of the amount of investment provided through forced savings.

Experiences of other underdeveloped countries [33] and our previous saving investment analysis show that monetary stability is more conducive to economic development.

Thus, the predominant objectives of monetary policy should be to promote economic stability by ironing out swings of inflation and deflation and by maintaining a relatively stable price structure. Monetary policy should be directed to achieve equilibrium between the demand for and supply of money in relation to the twin problems of growth and stability. Any lack of correspondence between the supply of and demand for money is at once reflected in the price-level. This indirectly inimical to both stability and growth for reasons of inelasticity of production. The function of the central bank is to make provision for the supply of money and credit to respond adequately to reasonalbe demand for investment finance. The rate of interest is the vital link that connects the volume of money and investment in an economy. This does not mean the supply of money is unimportant but its control is indirect to interest rate policy. [39] However, in an underdeveloped country like India with an underdeveloped and disorganised money market the supply of money has little connection with the complex and uncertain interest rate structure. Consequently, the central bank has not to exert greater control over the cost, availability and supply of money and credit. This brings us to the second objective of monetary policy, i.e. the regulation of credit from its undue expansion and canalization of credit in accordance with preplanned investment,

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[33] G.S,Dorrance, loc.cit.

[39] Monetary authorities should "regard interest rate structure rather than the supply on money as the centre piece of monetary mechanism". Radcliffe Committee Report, 1959. P.135

Control of credit is the chief weapon of monetary policy and main function of a central bank. "It is the function", observed De Kock, "which embraces the most important question of central banking policy and the one through which practically all other functions are united and made to serve a common purpose." [40] Credit Control is the principle means through which a central bank fulfills three objectives of monetary policy, i.e. economic stabilization, price stabilization and exchange stabilization. General credit control is aimed at the regulation the supply of bank-credit and money supply with a view to keeping the economy upon even keel. It is a difficult and challenging responsibility of the monetary authorities in underdeveloped countries to guide, both quantitatively and qualitatively the flow of funds into the directions whose spending is most favourable for investment and output without impairing relative stability of the economy.

In order to achieve monetary stability the central banks have developed various instruments to regulate bank credit, such as the discount rate, open market operations and variable reserve ratio. The effectiveness of traditional weapons of credit control like the Bank rate and open market operations depends on the existence of broad and active money and security markets. But, in most underdeveloped countries, these markets are in their infancy or disorganised, consequently, the central banks have neither the means nor the opportunity "for the marginal delicacies of discount rates and open market operations". [41] Even if these can be made effective their use may not be practicable expecially in those countries where the governments have embarked upon plans for economic development involving large-scale borrowing form the market. Hence, the current emphasis is on direct methods of credit control such as variable reserve ratio, and credit rationing. This does not mean that the

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[40] Central Banking, P. 134

[41] E.Nevin, Capital Funds in Underdeveloped Countries 1961, P.43

Bank rate and open market operations are useless in underdeveloped countries, but they need to be supplemented by direct methods of control, and all those should be used in changing combinations and with varying degrees of emphasis according to the structure of the economy and the ends to be achieved at a particular time.

Furthermore, from the point of view of development, quantitative methods of credit control, as described above, are not enough and the central bank should ensure that such credits as are available (and this will usually be inadequate in comparison with the total need for it) are used in the optimum way. The monetary authorities have clear duty to ensure that the distribution of credit, like the distribution of physical resources in the economy, is broadly consistent with the basic pattern of development. Hence, the central bank should possess adequate powers over the distribution of credit. The use of selective controls is customary in many advanced economies and the need for and the scarcity of resources is so much greater in underdeveloped countries that the imposition of some degree of control over its allocation is inevitable .[42] Such qualitative controls are important in encouraging the flow of funds towards sectors whose growth is hampered since the existing financial facilities are inadequate and particularly so, in preventing the misdirection of the flow of credit. As it has been noted by the International Bank for Reconstruction and Development, the experience many underdeveloped countries in recent years has shown that there has been a lack of the right type of financial institutions and also an excessive diversion of their resources into short-term, often speculative, types of activity, with little contribution to the types of investment most needed by the economy.[43]

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[42] J.G.Patel, "Selective Credit Control in Underdeveloped Economies", J.M.F. Staff Papers, September 1954, E.Nevin, Op.cit. P.64, Ervin Miller "Monetary Policy in a Changing World", Quarterly Journal of Economies, February 1956.

[43] Statement by the I.B.R.D. Methods of Financing Economic Development in Underdeveloped Countries, 1949, PP 92-3

The quantitative and qualitative flow of resources to channels compatible with planned investment programme presupposes the existence and proper development of financial institutions through which the task is to be accomplished. The task of the monetary authorities is relatively easier in advanced countries with well-developed and integrated financial institutions and credit structure. But the financial environment in underdeveloped countries is far from satisfactory. There are large non-monetizedsectors, currency and not bank deposit from major portion of the money supply, commercial banking is not yet fully developed and the money and capital markets are in their early stage of growth. A well-integrated banking system, specialized financial institutions and investment services which characterize advanced countries to-day and provide the basis from which a central bank can operate to make its policy effective, are lacking in most of the underdeveloped countries. The essential pre-requisite of central banking are non-existent and the central bank will have to create them.

Thus, the third objective of monetary policy in underdeveloped countries is the creation, expansion and regulation of these institutions. This will be the reversal of the usual process, but that is inevitable ; because to leave those institutions to market forces to develop would involve considerable time. The tratidional policy of extreme ease and aloofness on the part of the central bankers can be obstacle removing ; it cam ot create institutions. Our new monetary authorities have to start building institutions. As Prof. Sayers has observed, "the central bank has to step in and fill the gap in the credit structure which would otherwise remain unfilled." [44] Without a suitable institutional set-up, a central bank has only certain limited uses in maintaining stability of pri ces, income and value of the currency in the country concerned. Thus, the stabilization objective of monetary policy directly points to the development objective of central banking, i.e. the building up of a

[44] "Central Banking in Underdeveloped Countries" in Central Banking After Bagehot, 1957, Chapter 9, P. 118.

proper financial and credit structure which is the financial infrastructure of future economic development. [45] This would no doubt involve the monetary authorities in underdeveloped countries in wide range of activities than would be necessary in an advanced economy.

The need for the creation of financial institutions is of paramount importance in underdeveloped countries ; in fact, this is probably the biggest single objective of monetary policy. Institutions help to foster the habit of larger savings and to promote greater investment. Driblets of savings are concentrated and channelled into bigger investment projects. Sometimes we think of financial institutions which undertake direct borrowing and lending like the commercial banks ; the growth of a nation-wide banking system is important. But financial intermediaries are also equally important. The intermediaries are not only a link between the issuer and the buyer of securities, but they may also purchase those securities themselves and issue, in turn, their own securities. This creation of indirect debt and of primary security portfolio by financial intermediaries are alternativeto monetary growth. The success or otherwise of monetary policy depends on the existence of a whole range of institutions engaged in the short-end of the market like dealings in Treasury bills and call loans to long-term financing. Any consonance between short and long-term rates is dependent upon the growth of those institutions ; the closer movements between to the two rates in developed countries is due to the institutionalisation of savings and investment. Irrespective of whether the monetary policy operates at the short-end or at the long-end of the market is doomed to failure when the institutions are not there or not sufficiently developed to create responsiveness into the system.

Although most of the elements constituting a money

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[45] E. Nevin, op. cit.

market are present in India, yet we do not have a developed and integrated money market which can give meaningful content to the monetary policy of the Reserve Bank. There is such a lack of financial intermediaries that the role of such investments as Treasury bills and Call Money is not properly appreciated in India. The Capital market is in its infancy and at the mercy of reckless speculators. Such institutions as industrial banks, investment houses, building societies and other institutions for long-term finance simply do not exist. Most important institutions are the commercial banks, the control of which is the chief instruments of monetary policy. But banking facilities in India are far inadequate to meet the needs of the economy ; the most urgent requirement is that the banking facilities should be spread as rapidly as possible.

The Reserve Bank of India has, of late, draconian power to control the commercial banks through various weapons of credit control and other direct powers, but central banking control in India is far from satisfactory, partly because the banking organisation in unresponsive of the Reserve Bank of India. On many occasions the Bank drifted with the course of events without making statements of its policy or giving a lead to the market. The present dualism in the Indian money market also considerably reduces the efficiency of central banking control ; and measures should be taken to integrate the two factions of the market either by rapid extension of the organised sector and/or by institutionalization of the indigenous sector. Often the Reserve Bank uses methods which are relevant to monetary conditions of developed countries. Not that these methods are not required but they are not sufficient. In the following chapter we shall examine the monetary policy of the Reserve Bank of India, its operations and the effectiveness of various credit instruments employed by the Bank. But before that a detailed analysis of the monetary

set-up and institutional arrangements in India and of the circumstances leading to the establishment of the Reserve Bank and its constitutional frame work would be a great help towards the understanding of the monetary policy and operations of the Reserve Bank of India.

CHAPTER II

SCOPE OF CENTRAL BANKING IN INDIA

The effectiveness of monetary policy in an economic system is largely conditioned by the institutional and structural factors existing in that economy. Monetary management is largely governed by the institutional arrangements like the use of credit, credit consciousness of the people and their preferences, the structure of the banking system and banking habits of the people as a whole, The scope of central banking as a technique of monetary management depends on the existence of a well organised money market and proper coordination between its various component parts. Again, unless a large proportion of the money supply belongs to this market, the effectiveness of central banking operations to keep the economy on an even keel is limited. Besides, the elasticity and breadth of the money and capital markets make all the difference. An advanced economy is highly responsive and flexible, and any impulse in an economic organ is transmitted smoothly and effectively throughout the economy without institutional inhibitions. [1] Such a phenomenon is conspicuously absent in an underdeveloped economy like Inida where the type of impulse is impeded at every stage by rigidities, inelasticities and uncertainties that characterise a backward system of production and exchange. Hence "the understanding of the working of the monetary system, whatever it involves, involves also an accurate knowledge of all the processes and mechanisms which are what they are because of

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[1] D.R. Khatkhate, Problems of Monetary policy in a Developing Economy P. 22

a set of specific institutional and structural facts, and which would be very different if these institutional and structural facts were different from what they are." [2] Here we shall analyse the economic conditions, institutional and structural factors obtaining in India and see how far they influence the scope of monetary management by the Reserve Bank of India.

THE SUPPLY OF MONEY

The supply of money is an appropriate starting point for a study of the scope of central banking as the quantum, character and composition of money largely determine the degree of backwardness or advancement of an economy. It is a truism that monetary management is of little significance in an economy where a barter system prevails in most or certain important sectors, Similarly, the role of central banking as an instrument of monetary policy is limited in a society where the members insist upon use of coins and currency notes in making payments as against credit habits and deposit banking of more advanced countries. The pattern of money supply also throws light on how the variations in the demand for money should be met. The movements of currency, deposits and credits are important indicators of what is going on in the economy and what should be the course of action by the monetary authorities. Further, when studied over a period of time it suggests the functional relationship between different forms of money and it can also be interpreted so as to bring out the manner in which the liquidity preference of the community tends to express itself under changing circumstances.

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[2] A.W. Marget ; American Economic Review, December 1942.

The Reserve Bank's calculation of money supply in India is comprised of the following items :

1) notes and coins in circulation
2) demands deposits of the commercial banks
3) certain special deposits with the Reserve Bank

The first two items are self-explanotory and the third item is of minor importance if the State Governments' deposit with the Reserve Bank are excluded. The table shows the money supply in India of some selected years since the inception of the Reserve Bank of India in 1935 to 1960-61.

TABLE I

MONEY SUPPLY IN INDIA
(In crores of rupees)

y e a r	Notes in Circulation	Rupee Coins in Circulation	Demand deposits of Banks
1935	161'6	158'0	250'0
1945-46	1,218'8	165'7	787'1
1947-48	1,304'3	155'3	822'0
1949-50*	1,120'4	132'6	649'7
1950-51	1,238'6	144'1	640'3
1951-52	1,128'3	131'1	587'2
1952-53	1,119'1	125'2	565'5
1953-54	1,150'2	120'7	564'5
1954-55	1,236'4	115'0	608'9
1955-56	1,424'2	123'5	679'2
1956-57	1,483'2	118'3	756'4
1957-58	1,536'0	117'0	782'2
1958-59	1,658'4	121'4	774'2
1959-60	1,801'7	131'2	840'4
1960-61	1,941'6	141'7	874'8

* Figures since 1949-50 refer to Indian Union only.

Note : a) The total money supply does not include the amount of small coins. However, since that amount is not a significant proportion of the total money supply, it does not make any material difference to our analasis.

b) Banks include scheduled, non-scheduled, State Cooperative banks and the Reserve Bank of India.

Source : The Reserve Bank of India, Annual Reports on Currency and Finance.

The above table suggests that in the composition of the total money supply in India, the share of demand deposits has been on a diminishing scale. In 1935 the percentage of deposit money in the total money supply was 44, it declined to 36 in 1947-48 and to 33 after 1951-52 and to even less after 1955-56. By 1960-61 the demand deposits were barely 30 % of the total money supply ; and currency formed a very large proportion, about two-thirds or more of the money supply. This means that each stage of credit creation by banks would involve a considerable outgo of currency, though not necessarily in the above ratio. A major portion of cash circulates in the economy without returning to the banking system in the form of deposits. This structural narrowness of the monetary set up reduces considerably the capacity of the banking system to create fresh credit on the basis of an increase in its reserves, and correspondingly limits its power of multiple expansion of credit.

The reason for this may be ascribed to such factors as rising costs of production and living, high taxation, a fall in the earnings of the companies and firms, shrinkage in the saving capacity of the higher and upper middle class, withdrawal of past savings by the middle calss and evacuees from Pakistan, the shift of saving capacity to the lower classes who have not yet formed the banking habit, repatriation of foreign capital and nervousness in the minds of people created by the recent bank failures. All these factors have, no doubt, contributed to a more recent fall in the ratio of demand deposits in the total money supply in India. Some of these factors are not uncommon to other countries and a wartime and post-war proportionate decline in deposit money have been noticeable in many countries including developed ones. [3] But there are other factors, more

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[3] Vera Lutz, "Salient Trends in Commercial Banking", The Banker, February 1952.

secular in nature and peculiar to underdeveloped countries and which are in operation in India to account for the declining ratio of deposits to the total money supply.

One of the noteable but not so easily discerned long-term factors influencing the composition of money supply in India, as in other underdeveloped countries, is the monetization of the economy. The process of monetization of the non-monetized or partially monetized sectors is not only monetary but also a complex socio-economic phenomenon. The process has been going on for centuries but at a very slow speed. About one third of the volume of activity in the economy, especially in the production of food grains is still outside the pale of monetary transaction. However, since the Second World War the frontiers of the money economy have expanded owing to the structural changes brought about by the war and the massive impact of large-scale programme of planned economic development in the post-war period. Whenever monetization proceeds, a greater demand for money follows it, and as those areas or sectors where money is introduced cannot be readily served with banking facilities, it is the demand for currency that affects the composition of money supply ; and in the absence of new currency issue coming forth, bank deposits are bound to experience a relative decline.

It is not possible to estimate statistically how much currency is needed each year or each decade for the monetization of the economy. Since there is no mechanism by means of which the process of monetization and the issue of new currency could be correlated it becomes difficult for the monetary authorities to lay down criteria to determine whether the economy is short or has an excess of money supply. An important result of this is that the transaction demand for money becomes a variable and not a constant factor in relation to national income. National income remaining the same, the transaction demand for money will change as monetization of the economy changes.[4] In the short-period the effects may be negligible,

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[4] J.D.Sethi, Problems of Monetary Policy in an Underdeveloped Economy, 1961, P.8.

but over a long-period these will be of importance. Even over a period of two to five years the effects may be well pronounced, if, for example, large-scale monetary investment is undertaken, as is being done under the existing plans in the largely non-monetized sectors. Thus, one definite effect of the monetization process will be to raise the proportion of currency to deposit money unless accompanied by the banking development of the same order or supported by increased velocity of circulation of non-bank money. [5]

There are other factors which are responsible for the decline of the ratio of deposits to currency since 1935. It was due also to continuous budget deficits over these years and balance of payment deficits for most of the years, the combined effect of which was bound to swing the ratio in favour of currency. This is so because a budget deficit affects currency more than it does deposits and a balance of payment deficit affects deposits more. Moreover, a shift in the value of the share of agriculture in national income - a sector untouched by modern banking - affects, ceteris paribus, the ratio of deposits to currency. A rise in the share of this sector relative to others will reduce deposits and vice-versa. The former trend was noticeable throughout the greater part of the post-war period. This happened first with relative shift of prices of agricultural products rising more than those of industrial products form 1947 to 1951 and later by a higher level of agricultural production compared to that of manufacturers' during the first Five-Year Plan. The result was that the ratio of demand deposit in the total money supply declined to 31 % by 1955-56. Since then, however, the emphasis has changed, the Second and the Third Five-Year Plans purport to rectify the imbalance between agriculture and industry by a heavy reliance on the latter. It should be pointed out, however, that to reach a position of deposits being a multiple of currency, as found in advanced economies, is going to be a lengthy process.

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[5] The Reserve Bank of India, Trends and Progress of Banking in India, 1956, P.8.

It must be admitted that inspite of the relative decline in the ratio of demand deposits to currency the growth of the total bank deposits has been rapid. Reflecting the growth of the economy under planning, the total liabilities of the scheduled banks more than doubled between 1951 and 1961. The total deposits of all scheduled banks rose from Rs. 856 crores in 1950-51 to Rs. 899 crores in 1954-55. Since then increases have been rapid, in 1955-56 it rose to Rs. 1003 crores and reached an all time record of Rs. 1915 crores and this brought the ratio of total bank deposits to currency in circulation to near unity. This no doubt shows the popularity of the banks among the public. But this statement cannot be accepted without due caution. The total volume of bank deposits cannot be taken as a true indicator of the popularity of bank accounts among people as medium of transaction. The reasons for this scepticism are :

1) bank deposits are confined to educated and well-to-do people of the cities and big towns
2) since the banks in India pay interest even on demand deposits, the depositors treat such deposits as investment and a source of steady income than using bank account as a means of settling accounts.

For them banks are safe and convenient resting places for their surplus money or for the accumulation of working capital. This point has augmented by the fact that demand deposits which were 57 % of total deposits at the end of 1950 were reduced in relative importance to 36 % of the total by October 1960, although between the two dates they had risen by about 20 per cent. On the other hand, time deposits expanded by nearly two and a half times during the same period, their proportion to total deposit rising from 27 % to 47 per cent. [6] The growth in time deposit could be attributed in part to the relatively higher rates offered for those deposits and also to the spread of the banking habit, particularly in the case of personal accounts. At the end of 1961, personal accounts claimed 83 % of total account holders and 50 % of the total deposits.

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[6] The Reserve Bank of India, The Trends and Progress of Banking in India, 1961, P. 6.

Thus, the growth of bank deposits indicates two basic facts, viz. the expansion of banking system in the country and their growing popularity. So far as the nature of monetary transactions is concerned it is primarily on an individual to individual basis and not through banks, and notes and coins hold their ground as a medium of payment for the vast majority of people, though for a limited but growing sector bank deposits have come to play an increasing role in transacting payments. Thus, the liquidity preference of the people in favour of coins and notes has set up a monetary pattern which presents a hard task for the Reserve Bank of India to exercise an effective and prompt regulation of credit through the usual central banking operations. [7] The regulation of the currency notes has formed the principle instrument of monetary management by the Reserve Bank. Here again, as admitted by the Bank "the regulation of money supply is not wholly or even largely under Bank's control. It is condiderably affected by the budgetary operations of the Government over which the Bank has no control, although the Bank has opportunities of tending advice to the Government on the matter. [8]

FLUCTUATIONS IN THE DEMAND FOR AND SUPPLY OF MONEY

The liquidity pattern is also subject to the most volatile variables from the viewpoint of short-term monetary policy, namely violent seasonal fluctuations in the demand for and supply of money. Generally there are two seasons which cut

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[7] "The more a community is acquainted with the use of credit and the less insistent it is on cent per cent liquidity (i.e. on holding cash) the greater are likely to be quantitative effects of a marginal unit of legal tender on subsequent debt creation. But since notes from the most popular medium of circulation in India... the monetary authority in charge of note-issue has to expand and contract its liabilities on a larger scale than if bank deposits were more commonly used." K.R.Raj, The Monetary Policy of the Reserve Bank of India 1948, P. 36.

[8] The Reserve Bank of India : Function and Operations P. 11

across both the calender and financial year : the slack season extends from May to October and the busy season from November to April. [9] During the busy season important crops mature and their movement from places of production i.e. rural areas to markets and to foreign countries, requires addtionnal money supply.

It is a regular feature of the busy season that large scale expansion of currency takes place followed by an equally big increase in the bank credit. The normal ratio of bank credit is 45 % in the slack season which shoots up to about 65 % or even more during the busy season. In a country with a fully developed banking habit and extensive banking system these developments will also result in the expansion of deposits following the expansion of currency and credit. But in India the process is reversed. In the busy season deposits decline while currency expands and the opposite happens during the slack season, It is because the increased demand for money comes from the non-banking sector, i.e. the rural areas, which causes the withdrawl of money supply from the banking sector. The main characteristics of the busy season are :

1) expansion of currency
2) expansion of bank advances
3) contraction of deposits

And to this may be added the increased velocity of circulation of notes and coins. The following table indicates tne seasonal variations of the money supply with the public.

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[9] This periodicity could be shortened or prolonged by the very conditions of money supply. For example 1948-49, 1949-50 and 1950-51 busy seasons were prolonged and 1951-52 and 1952-53 slack seasons were of longer duration. Reports on Currency and Finance 1948-49 to 1952-53

TABLE 2

SEASONAL VARIATIONS IN MONEY SUPPLY WITH THE PUBLIC

(In crores of Rupees)

Year	S e a s o n	Currency with the public	Total Money Supply including Deposit Money
1938-39	a) April 16,1938 to August 26,1938	- 27'57	- 25'63
	b) August 27,1938 to March 31,1939	+ 11'55	+ 14'87
1947-48	a) April 12,1947 to September 26,1947	- 90'74	- 75'71
	b) September 27,1947 to April 30,1948	+ 145'48	+ 208'16
1951-52	a) May 12,1951 to October 26,1951	- 193'40	- 221'00
	b) October 27,1951 to April 11,1952	+ 53'30	+ 12'40
1953-54	a) May 9, 1953 to September 25, 1953	- 124'60	- 122'50
	b) September 26,1953 to May 7, 1954	+ 155'00	+ 171'20
1955-56	a) May 7,1955 to September 23,1955	- 11'50	- 10'10
	b) September 24,1955 to May 8,1956	+ 206'80	+ 249'90
1956-57	a) May 9,1956 to October 1956	- 96,50	- 106'00
	b) November 1956 to April 1957	+ 145'90	+ 234'90
1958-59	a) May 1958 to October 1958	- 89'20	- 147'10
	b) November 1958 to April 1959	+ 222'40	+ 290'60
1960-61	a) May 1960 to October 1960	- 89'40	- 79'20
	b) November 1960 to April 1961	+ 205'20	+ 235'30

Note : a) and b) indicate slack and busy season periods respectively

Source : The Reserve Bank of India, Annual Reports on Currency and Finance.

This expansion of currency takes place through four channels:

1) increase in commercial banks' borrowings from the Reserve Bank of India
2) liquidation of Government securities in favour of the Reserve Bank
3) decline in banks' deposits with the Reserve Bank
4) decline in the cash ratio of the commercial banks

These trends will be evident from the table below

TABLE 3

SEASONAL TRENDS IN THE CASH RATIO, ADVANCE RATIO AND INVESTMENT RATIO OF SCHEDULED BANKS

(In lakhs of Ruppes)

Year and Season	Cash balances with the Reserve Bank	Cash ratio at the end of the period	Borrowings from the Reserve Bank	Investment in Government securities	Investment ratio at the end of the period	Bank credit and advances	Credit deposit ratio at the end of the period
Slack 1950	+ 26,99	13'0	- 8,22	+ 37,86	43'1	- 74,43	47'7
Busy 1950-51	- 25,21	9'9	+ 9,24	- 65,91	34'8	+ 163,43	65'4
Slack 1955	+ 12,41	9'1	- 21,37	+ 47,71	38'4	- 31,55	58'0
Busy 1955-56	- 6,74	8'1	+ 50,35	- 36,93	33'4	+ 164,49	71'2
Slack 1956	+ 1,02	8'0	+ 1,91	+ 16,09	34'2	+ 3,67	70'0
Busy 1956-57	+ 16,00	8'5	+ 14,90	- 26,96	28'9	+ 148,42	74'5
Slack 1958	+ 13,66	9'3	- 17,59	+ 174,75	39'3	- 117,91	53'2
Busy 1958-59	- 14,61	7'8	+ 24,94	- 3,18	36'4	+ 181,70	60,3
Slack 1959	- 21,11	6'2	- 13,35	+ 178,00	44'2	- 78,95	52'3
Busy 1959-60	+ 29,67	7'3	+ 29,80	- 52,49	38'4	+ 188,93	58'6
Slack 1960	+ 4,17	7'6	- 27,02	- 52,33	36'2	- 20,31	58'2
Busy 1960-61	- 23,24	6'3	+ 21,53	- 126,32	29'4	+ 198'53	68'3

Note : The Slack Season is from May to October and Busy Season is from November to April

Source : The Reserve Bank of India, Annual Reports on Currency and Finance.

The alternate seasonal rise or fall in the supply of demand for money is a normal feature of the Indian monetary economy and will remain so as long as the seasonal character of production is there. In the long-run it is the diversification of the structure of production and a balance between various sectors of the economy which can modify this seasonal character of the money supply.

The Reserve Bank of India decides its short term monetary policy at the beginning of each busy season with reference to changes in the previous busy and slack seasons. During the busy season money supply expands to meet the seasonal demand. As this expansion takes place through the extension of Reserve Bank credit to the banking system and through the latter to the non-banking sector, the Reserve Bank naturally expects that this additional currency will be returned to it by the same way, including the private deposits of the commercial banks.

Now, if this does not happen and the currency and deposits do not flow back to the banking sector, the Reserve Bank takes a serious view of the situation. The Reserve Bank puts great emphasis on knowing the ultimate use of additional funds for fear of dangerous results which speculation might engender and the Bank has repeatedly emphasised the role of speculation on money conditions working through commodity hoarding. But because the newly created money does not return to the banking system during the slack period it should not be necessarily inferred that it is illegitimately retained in the economy. Even if there is no change in national income and there is no change in the speculative hoarding of money in the Keynesian two- dimensional analysis, the demand for money may still be elastic because of the monetization of the non-monetized sectors, the relative share of agriculture in the economy and the non-speculative hoarding of money, i.e. savings in the rural sector. [10] For a long time the Reserve Bank failed

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[10] J.D- Sethi, Ibid, P. 33

to appreciate the importance of these factors which may reasonably preclude the need or the possibility of the return in the slack season of the whole or a large part of the additional money supply. Recently, however, the Reserve Bank has started taking a realistic view of the situation and pursuing a policy of what it calls controlled expansion (or contraction) of money supply if seasonal changes in money supply are distored. [11]

INSTITUTIONAL STRUCTURE

It is needless to emphasise the role of the banking system and other financial intermediaries which comprise the super-structure of credit organisation and form the basis from which the central can operate to make its monetary policy effective. The scope of central banking is largely conditioned by the existence of a well-developed banking system and money market in the country.

In India banking on modern lines was first started in the early part of the nineteenth century, but real progress was made only after 1860 when the principle of limited liability was applied to the joint-stock banks. But India has her own time honoured system of banking which is usually a personalised institution built around a single person or a joint-family. These ancient institutions are the peculiar product of the socio-economic history of India. As a result of the existence of the two banking system -the modern and the ancient- side by side, the Indian money market is also divided into two sectors : the organised and the unorganised or indigenous money markets.

The organised sector of the money market consists of the Reserve Bank of India, the Imperial Bank of India (now State Bank of India), the Indian joint-stock banks, the foreign exchange

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[11] This analysis was presented for the first time in the Annual Reports on Currency and Finance of 1955-56 and 1956-57.

banks, the cooperative banks, stock exchange, insurance companies and large corporations which are active lenders at the short-end of the market and their funds are known as "house money". The indigenous market or what is some times known as "bazaar market" consists of indigenous bankers,money lenders and Gunrati, Multani and Marwari shroffs -each with a different business practice and a different structure of interest rates. The unorganised market occuppies a more important place in relation to the total resources of the country but the two sectors of the money market are not integrated into an organic whole whereby any impulse in one sector is transmitted readily and effectively into the other. Whatever influence the Reserve Bank has is mainly confined to the organised sector. On occasion and at particular times forces in operation in the organised sector have spilled over into the other but such leakages do not mean an integration of the two sectors of the Indian money market. When the Reserve Bank of India was established in 1935, efforts were made to bring the indigenous bankers within the radius of central banking control. But these efforts proved unsuccessful [12] and the position has broadly remained unchanged since then.

The organised Sector :

The organised sector of the Indian money market is primarily composed of commercial banks scheduled and non-scheduled banks and cooperative banks. Considering the continental character of the country the banking development is most inadequate to meet the needs of trade, industry, agriculture and commerce. Immediately after the Second World War the banking system

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[12] The Statutory Report of the Reserve Bank,1936;for detailed correspondence between the Reserve Bank and the organisagion of indigenous bankers, see PP. 25-35.

emerged disorganised as a result of hapazard war-time growth[13] and many small and medium sized banks went into liquidation. In order to rectify some of those defects the Government of India in consultation with the Reserve Bank placed on the statute book, the fairly comprehensive Banking Companies Act in 1949. The total number of banks, both scheduled and non-scheduled stood at 620 in 1949. Between 1949 and 1954 a large number of banks ceased to function as a result of liquidation and compulsory mergers ; and the total number of banks came to 382 at the end of December 1961 with a network of 5111 branches.[14]

At the end of December 1961 all commercial banks - scheduled and non-scheduled-[15] had aggregate deposits of Rs. 1868'0 crores ; of these 83 scheduled banks accounted for roughly 98 % of the total deposits and credits. The State Bank of India (previously the Imperial Bank of India but nationalised in July 1955) has the biggest commercial bank holding - about one-fifth of total bank deposits. Eight banks[16] which had close association with the State Government have been taken over a subsidiarie of the State Bank of India. They accoun-

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13 Between 1941 and 1945 there was a mushroom growth of banks with inadequate capital structure, unsound methods of operation, an extensive and costly branch network and unduly favourable terms of managerial appointments. K.N.R. Ramanujam Banking in India, in H.W. Aubur, Ed. comparative Banking, 1962, P. 77.

14 Trends and Progress of Banking in India, 1961, P. 23.

15 A bank must have a minimum paid-up capital and reserves of Rs. 5 lakhs in order to be included in the list of scheduled banks. The scheduled banks are like the member banks in the Rederal Reserve System.

16 These are :

1) the State Bank of Hydrabad
2) the State Bank of Bikaner
3) the State Bank of Indore
4) the State Bank of Jaipur
5) the State Bank of Travancore
6) the State Bank of Mysore
7) the State Bank of Patiala
8) the State Bank of Saurasta

ted for 6'7 % of total deposits and 9'6 % of the total number of bank offices. The fifteen foreign banks, known as exchange banks and generally specializing in the financing of foreign trade have deposits Rs. 233'5 crores. In recent years they have extended their activities from the ports where they operated to the interior. The Indian scheduled banks, other than the State Bank of India and its subsidiaries, number 59 and differ widely in their sizes - from banks with deposits of over two hundred crores of rupees to those with hardly a few lakhs of rupees and paid up capital and reserves barly enough for their inclusion in the list of scheduled banks. Their deposits amounted to Rs. 1020 crores or 59 % of deposits of all banks. If the scheduled banks are classified according to the size, fifteen banks with deposits of over Rs. 25'0 crores account for about 80 % of deposits of all scheduled banks. Non-scheduled banks number 299 at the end of December 1961. A majority of them are small sized units restricting their activities to small localities. The deposits of these banks amounted to Rs. 42'7 crores at the end of December 1961.

The underdeveloped nature of the banking system is illustrated by the fact that population served by banking offices in India is 86,000 as compared to 4,000 in the United Kingdom, 7,000 in the U.S.A. and 16,000 in Japan. The ratio of bank deposit to national income is hardly 15 % in India as compared to 36 % in the United Kingdom, 53 % in the U.S.A. and as much as 75 % in Japan. [17] Viewed from another angle per capita deposit in India is Rs. 47 whereas they are as high as Rs. 2000 in the United Kingdom, Rs. 6,000 in the U.S.A. and Rs. 1,480 in Japan. The geographical coverage is also hopelessly inadequate as slightly less than 3,000 towns in India do not possess any banking facility. Towns and villages with population below 5,000

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[17] K.N.R. Ramanujam, loc. cit.

which account for 70 % of the total population are hardly touched, with the exception of cooperative institutions, by modern banking facilities and towns up to 10,000 population are only partially served by banks. [18] Most of the banks and their branches are concentrated in cities and big towns and this configuration of banking facilities has created the defect of making Indian banking suffer from both over banking and under banking at the same time. There are, relatively speaking, too many banks in cities and too few banks outside the cities and big towns. It means, in rural India -an overwhelming part of India is rural- transactions are conducted either by barter or by currency or by indigenous instrument of credit. A significant result of this is that where as on the one hand there exists a most sophisticated system of exchange in the organised sector of the money market, on the other hand, primitive contitions of exchange persists in rural India.

The cooperative credit movement which was started in 1904 to supplant the indigenous bankers and money lenders and to reduce the burden of rural borrowers at their hand, after more than fifty years of existence has touched only the fringe of the problem. In 1952-53 the total number of cooperative institutions in the country was 178,972 made up of 17 State Cooperative Banks, 505 Central Cooperative Banks and Banking Unions, 557 supervising and guaranteeing Unions and 147,196 agricultural primary societies. The total number of members of the primary societies including agricultural and non-agricultural was 14'3 millions, The distribution of these cooperative societies are uneven and as a consequence the average number of societies affiliated to each Central Cooperative Bank is often to small to attract adequate business. Applying the two tests of the proportion of population that has benefited from it and the proportion of the rural financial needs supplied by it, the

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[18] Trends and Progress of Banking in India, 1961. Statement 27, Distribution of Banking Offices by Population in Several States as at the end of 1961. PP. 96 - 97.

progress of the movement must be pronounced disappointing, especially in the States other than Bombay, Madras and Punjab. The Reports of the Provincial Committes also make it clear that financial facilities provided by the movement to the rural population supply only a small part of its needs. [19]

However, since 1952-53 considerable progress has been made in the direction of cooperative credit movement, the coverage of population by the cooperative institutions was about 27 % in 1958. The number of primary agricultural credit societies and service co-operative societies increased to 2'15 lakhs by June 1961 with a membership of 17'3 million, which covered approximately one-third of the population, assuming a family of 7 persons engaged in agriculture and cottage industries. [20] But it is still far too inadequate to extricate the rural population from the grip of the money lenders with their exhorbitant rates of interest.

The provisions for long-term finance is conspicuously lacking in India as there is a complete absence of industrial banks, investment houses, investment trusts and building societies. The total savings of the community are not canalised into the organised capital market ; only a part comes to this market. This is mainly due to the lack of organised financial intermediary institutions through which savings of the community could be collected, as for instance, is done in developed countries. [21] This means that not only short-term fund but also long-term savings do not reach the capital market but go into the hands of money lenders, indigenous bankers and traders -most of whom combine trading with banking functions. Thus the nature and cha-

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[19] See Table 4

[20] The Reserve Bank of India, Annual Review of the Co-operative Movement in India

[21] For a detailed description see Reserve Bank of India, The Finance for the Private Sector, 1954.

racter of capital, i.e. loanable funds, is trading rather than industrial. The unorganised money markets are almost wholly concerned with the financing of trade. The organised market, in which commercial banks dominate is meant also to a large extent serve internal and external trade. Only one-third of the commercial banks' advances go to the industry as working capital. This trading character of capital is not peculiar to India, but it is true of all pre-industrial and semi-industrial societies.[22]

In the post-independence era at the initiative of the Government a number of institutions like Industrial Finance Corporation (1948), National Industrial Development Corporation (1954), Industrial Credit and Investment Corporation of India (1955) and Refinance Corporation of Industries (1958) were established for the financing of industries. The State Government also have set up Industrial Finance Corporations in their respective territories. All these institutions are in their infancy of growth and experience and it is too early to evaluate their efficacy in the national capital market.

The indigenous Sector

The unorganised or indigenous sector of the Indian money market is composed of hundreds and thousands of indigenous bankers and moneylenders scattered profusely all over India. For centuries the indigenous bankers and moneylenders are supplying credit to the agriculturists, small traders and manufacturers. The most characteristic feature of those creditors is that they are not regulated by any "law of the realm" and they are untouched by the formidable Banking Companies Act of 1949. The two categories -the indigenous bankers and moneylenders- are themselves different and diverse in their functions and methods of business. Although there is no watertight division between the

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[22]The Report, 1939, Vo. I, Pt. I, P. 73

two agencies in the unorganised sector of the Indian money market, according to L.C. Jain [23] an indigenous banker is any individual or private firm which, in addition to making loans, either accepts deposits or deals in hundis or both, each of which functions clearly belongs to the province of banking ; while a moneylender is an individual or private firm which makes loans but usually does not accept deposits or deal in hundis. The Indian Central Banking Enquiry Committee expressed similar views regarding the nature of business of the indigenous bankers and moneylenders. [24]

Moneylenders are known by different names such as sowcars, banias, mahajons, etc, in different part of the country. Reliable statistics are not available as to their number, resources of of the scale of their operations. The All Indian Rural Credit Survey estimated the figure between 300.000 to 350.000 ; but it seems the Survey has not taken into account of a large number of landlords and / or marchant-cum-moneylenders. [25] The Survey reveals some interesting figures as to the extent to which the main agencies of rural credit have contributed to the borrowings of the cultivators.

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[23] Indigenous Banking in India, 1929, P. 3.

[24] The report, 1931, Vo, I, Ot. I, P. 73.

[25] Mobilisation of Domestic Capital in Certain Countries of Asia and the Far East, United Nations, ECAFE, 1951, P. 131.

TABLE 4

CONTRIBUTION OF VARIOUS AGENCIES OF RURAL CREDIT

TO TOTAL BORROWINGS OF CULTIVATORS

(In per cent)

Credit Agencies	% of Total Borrowings
Government	3'3
Cooperatives	3'1
Commercial Banks	0'9
Relatives	14'2
Landlords	1'5
Agriculture Money Lenders	24'9
Professional Money Lenders	44'8
Traders & Commission Agents	5'5
Other	1'8
	Total 100'0

Source : Summary of Report of All-India Rural Credit Survey, The Reserve Bank of India, Bulletin, December 1954, P. 1183. This table is based on a survey which covered 127,343 families in 600 villages.

Thus, the moneylender, agricultural and professional together, supply 70 % of total loans to the agriculturists while the organised agencies, such as Government, cooperatives and

commercial banks, supply only 6'3 %. Other agencies like relatives, landlords and traders supply 23 % of the rural credit. It is obvious that moneylenders of various types dominate the scene and organised agencies play a subordinate role in the supply or rural credit.

The rate of interest for agricultural credit is conventional rather than competitive and varies from 15 % to 50 % depending upon the condition of local market and types of securities offered. Loans given without security carry much higher rates with a maximum of 300 per cent. The Pathans, Kabulis and Rohilla moneylenders charge as much as 75 % to 300 %.[26] During the past few decades attempts were made to curb the malpractices of the moneylenders by way of issuing licences to them which prescribed the maximum rate of interest and other terms of a loan. But so far such attempts have met with little success. From the view point of central banking control, Reserve Bank of India has no direct relationship with them, even though they play an important role in the creation of credit.

The indigenous bankers are referred to by different names in various parts of the country such as Chettias in South India, Marwaria and Multanies in North India and Shroffs in the State of Bombay. Generally they receive deposits, discount indigenous bills known as hundis and perform many other banking functions. They are to be found in the urban and rural areas and supply funds to small traders and manufacturers and moneylenders. With the establishment of joint-stock banks their position has detoriated in the cities and big towns, But even in these places, their position remains invulnerable in certain respects because they meet the particular needs of a community or local group or because they specialise in business where the commercial banks do not dare or care to enter. Their ways and methods of business are secret and vary from place to place. Their dealings with the customers are on a more personal basis

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[26] Banking Enquiry Committee Reports of Bengal, Bombay, Madras and U.P.. PP : 196, 210-11, 221-7, 31 and 280 respectively.

than the joint-stock banks and the rate of interest charged by them is more traditional than competitive.

Indigenous bankers have little connection with the organised sector of the Indian money market but some of them obtain credit facilities from the joint-stock banks where both types of banks co-exist -thus forming a link between the organised and the unorganised sectors. The credit instrument the indigenous bankers use most is known as hundi -an Indian version of bill of exchange. Some indigenous banks, whose names are on the approved list of the joint-stock banks and of the State Bank of India (formerly the Imperial Bank of India) obtain cash credit from them against demand promissory notes signed by two of the bankers, of discount with them hundis drawn by merchants and endorsed by the bankers, up to a certain limit, assigned by them of each banker. In majority of cases, however, the accomodation which the bankers obtain is not regular, and is sought occasionally and only during the busy season when their resources are strained. In discounting hundis, the banks prefer trade bills to finance bills because they inspire more confidence, being backed by actual goods,The general impression is that the iddigenous bankers do not receive all the support that they should get from the Imperial Bank (State Bank of India) and the joint-stock banks. [27]

There is no correlation of operations of the banks and of the bazaar consisting of the indigenous bankers ; and the bazaar hundi rate is often different from and much higher than the banks' rate for discounting hundis. Further more, no

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[27] Bombay and the U.P. Banking Enquiry Committee Reports, PP. 201 and 274. The Bengal Banking Enquiry Committee also expressed a lack of consideration by some branches of the Imperial Bank.

direct connection has yet been established between this vital sector of the Indian money market and the monetary authorities. The bazaar market operate more or less independently of the organised sector and generally does not show automatic reponse to the changes in credit conditions and discount rate policy of the Reserve Bank of India. In the absence of a close cooperation between the Reserve Bank, indigenous banks and joint-stock banks the development of a regular discount market or a coordinated credit policy is impossible and the efficacy of the monetary policy of the Reserve Bank of India is bound to be hampered.

In view of the importance of the indigenous bankers in the Indian banking business, the Reserve Bank made several attempts to establish direct links between the indigenous bankers and itself, but so far without success. The problem, therefore, is either to integrate this vital sector of unorganised money market with the organised system, removing some of the objectionable methods of business, which exists or to secure complete elimination of them by the gradual substitution of institutional machinery. But as the Rural Banking Enquiry Committee has observed "the private moneylender has to be tolerated as a necessary evil for many years to come and that nothing would be gained by depriving the majority of agriculturists of even the existing facilities for credit, long before alternative supply could be arranged." [29] As also recently observed by the Deputy Governor of the Reserve Bank of India, "it is in this context that we have to explain the various efforts made by the Reserve Bank to extend the area of organised commercial banking or to help set up a cooperative credit system. In either case, the attempt is to effect a transition from the individual to the institutional, from the unorganised to the organised. Control implies organisation and monetary management must remain incomplete

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[29] The Report of the Rural Banking Enquiry Committee, 1950, P.52.

if, outside rather a restricted area, there is nothing to regulate or manage." [30]

STRUCTURE OF RATES OF INTEREST

In developed countries the various constituents of the money market are closely inter-related making it one organic whole but in India the monetary system works through a complex of loosely knit markets. In the indigenous sector the rate of interest varies from place to place and from time to time. The bazaar rates of Bombay, Calcutta and Madras are different and even in these cities there are different rates in the Multani, Marwari and Gujrati bazaars. The conditions are far from satisfactory even in the organised sector of the money market where the commercial banks dominate. In developed money markets like that of London and New York the Bank Rate is the prime rate and the whole spectrum of short-term rates are conventionally adjusted to that rate. But in India there is no convention or agreement to determine the different short-term rates in relation to the discount rate of the Reserve Bank of India. The bazaar rates for discounting small traders' bill differ widely from the Reserve Bank discount rate and there are differentials of a very high order in the various rates of the commercial banks.

In England and in the U.S.A. banks have long abandoned the practice of paying interest on current deposits. In India, all banks, with the exception of the State Bank of India, have been paying interest on current deposits. The deposit rates of different banks in Bombay vary from 1 % to 5 % according to the nature of the deposits. If rates are compared between Bombay, Calcutta and Madras, the variations will be wider. In England and in the U.S.A. deposits rates are usually 2 % below the Bank rate. This fixed margin avoids unhealthy competition among banks for deposits and assures them a fair rate of return. But in India,

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[30] The Reserve Bank of India Bulletin, January 1961, P.13.

the deposit rates have little connection with the Bank rate or the advance rate of the State Bank of India. The rate for three-months deposit varies from ½ % to 4½ %, which is very near to the level of short-term and call loan rates with a bare margin sometimes for costs. Even then there is no consistency between the advanced rate and the hundi rate of the State Bank of India - sometimes one is below or above the other - though the security behind them is equal in every respect. There are also disparities between the call loan rates of Bombay, Calcutta and Madras and the differences between these rates and the treasury bill rate are rather wide. The rates quoted by banks for loans and advances vary very much according to the areas in which they operate, the nature of business on which they concentrate and in accordance with the competition they have to face and not so much with reference to the prevailing Bank rate. Consequently the advance rate varies from 4 % to 7 % or 8 % where as the advanced rates in England and in the U.S.A. are usually ½ % to 2 % above the Bank rate with a minimum of 4 % to 5 % in all circumstances. Bazaar rate varies from 6 % to 15 %.

There is no one dominating rate of interest in the sense of giving an integrated structure, the whole structure stands at a high level compared to its counterparts in developed countries, most rates are institutionally determined and less flexible and lastly the range of different rates is too wide. There is no convention or arrangement whereby the whole spectrum of short-term rates automatically follow the movements of the discount rate of the Reserve Bank, consequently the Bank rate has less importance. The indefinitness of the relation between the rates make it difficult for the monetary authorities to decide upon the best line along which credit instruments and credit procedures should develop. The simultaneous existence of an inter-bank call rate of 2 %, a hundi rate of 4½ %, a Bank rate of 3½ %, a Bombay bazaar rate 9 % and a Calcutta bazaar rate of 11 % indicate an extraordinary sluggishness in the movement of funds between the various component parts of the Indian money

market. [31] Such a state of affairs leaves the Reserve Bank in a prejudical position as to the effectiveness of its monetary policy operating through a flexible interest policy.

The rate of interest plays the crucial role in regulating credit and investment finance, and the smooth and unhindered flow of funds is as necessary a condition of effective monetary policy as the efficient and well-organised money market. But the loose, haphazard and undisciplined nature of the Indian money market can have no better index than the diversity and multiplicity of rates of interest. Under the existing market conditions the supply of money has no relation whatsoever with the complex and complicated interest rate structure. The heterogeneity of market rates make it essential that not only the monetary authorities should have greater control over the supply of credit, but also ensure that the supply of funds is employed for the purpose for which they were originally supplied through the selective mechanism. [32] The problem is not just one of lowering or raising the interest rate, it is one of operation an integrated credit policy which takes account of the diversified needs of an economy which after years of stagnation has set itself on a path of long-term planned development.

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[31] A similar observation was made in 1931 by the Indian Cebtral Banking Enquiry Committee, vol. 1, Pt. 1, P. 400. In recent years these disparities have been some what reduced, but the broad picture remains the same since the days of the Committe.

[32] K.N. Raj, Ibid, P. 45.

CHAPTER III

EVOLUTION AND ORGANIZATION OF THE RESERVE BANK OF INDIA

Central banking is a comparatively recent innovation in the Indian economy. Monetary policy and management in the sense of central banking control of cost, availability, quantity and direction of credit and currency did not really become apparent until the thirties of the present century when the Reserve Bank of India appeared in the monetary scene of India. Prior to that time all the emphasis was on currency problems ; monetary affairs were strictly confined to the regulation of currency and coinage, and the development of a national banking system was virtually ignored. The details of the currency controversies of a century before the establishment of a central bank in India in 1935 are outside the scope of this study but it is necessary to outline, in brief, some of the salient features of that currency system and the circumstance that let to the "birth" of the Reserve Bank of India.

EARLIER CURRENCY CONTROVERSIES AND PROPOSALS FOR A CENTRAL BANK IN INDIA

When the East India Company turned from being traders to being rulers of India their first important task was to standardise the currency by introducing a unified coinage system in the midst of multitude of vastly different coinages. Accordingly, a uniform currency was established under the Gold and Silver Coinage Act of 1835, whereby the silver-rupee [1] was adopted as the standard coin for British India. This was followed, in some

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[1] The silver-rupee wighted 180 grains, out of which 165 grains were of pure silver.

cases slightly preceded, by the establishment of a number of modern banks ; the most notable of them were the Presidency Banks of Bengal, Bombay and Madras. The Presidency Banks had a semi-official character and were no more than the financial branches of the East India Company's main offices. Nevertheless these Banks had the rights of note-issue, but in 1861 the right of note-issue by private banks was abolished and substituted by the Government currency. This was in keeping with then monetary trends of separating the currency issue from the banking business in many European countries, but it was directly influenced by the British practice as appeared in the Bank of England Act of 1844.

In 1858 the administration of India passed from the hands of the East company to the British Crown. As a hallmark of that political event proposals for a Government currency were instituted in 1859 by Mr. James Wilson on his coming to India as the First Finance Member of the Council. It is interesting to note that the first proposal of a Government currency was in favour of a proportional reserve system, and this also referred to the establishment of a national banking corporation "adequate to the requirements of the trade of the country and through which all business of the Government may be transacted .... which might infact represent the banking department of the Bank of England." [2] But neither of these were acceptable to the authorities in London, who were still obsessed with the Bank Charter Act of 1844, and insisted on the adoption of the "sound principle" of fixed ficudiary issue. [3]

As some compensation to the Presidency Banks for their being deprived of the right of note-issue, they were allowed to hold the Government balance free of interest payment. There was no restriction of the use of funds up to a certain specified limit but amounts held in excess of that had to be held either

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[2] Financial Letter from the Governar General, December 29, 1859 No 2. Minute by Mr. Wilson

[3] Financial Despatch from the Secretary of State, March 26, 1860.

in cash or in Government securities. When this arrangement failed to work in an emergency in 1863 the Government relaxed those conditions, subject to only one condition that the Banks were under obligation to pay on demand at any time. Thus, began the practice of leaving Government balances with the Banks which could be used for the rediscounting of commercial bills. This appears as an experiment in the semi-central banking in the monetary system of India.

In subsequent years the possibility of the Presidency Bank of Bengal developing into a "Bank of India" was discussed constantly, and the successive Finance Members were not unfriendly to the idea. [4] But such a possibility disappeared in 1974 when the Government wanted to withdraw a large sum at short notice and the Bank made difficulties. The Government of India, therefore, decided to revise the system to become independent of the financial vagaries of the Presidency Banks. An efficient solution to the problem would have been to amalgamate the three Presidency Banks into one central bank, as suggested by the Secretary and Treasurer of the Bank of Bengal, Mr. Dickson in 1867, with a single dependable reserve and to entrust the new institution with the responsibility of transacting all the financial business of the Government. But the Government of India, without giving any serious consideration to that suggestion, established the independent Treasury in 1876.

This unnatural divorce between currency and banking and the failure of the Government to grasp the significance of developing and encouraging wider use of credit, contributed to the very high rates prevailing in the Indian money market during the busy season. The Secretary of State, while withdrawing its balance from the Presidency Banks, suggested that the Government should aid the money market by entering it and by competing in the banking business. Such an idea was unacceptable to the Governor General Lord Northbrook, who remarked:"It is not, in

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[4] J.M. Keynes, Indian Currency and Finance, 1913, P. 234.

my opinion, the business of the Government of India to finance Indian trade, it is the business of commerce to finance Indian trade." [5]

Such a narrow approach to banking and the adoption of fixed fiduciary system of issue under the silver standard together created a situation whereby the elasticity of supply of currency became practically dependent upon the supply of silver bullion. There was, thus, a close correlation between the Bank Rate of the Bank of Bengal and the rate of annual silver imports. [6]

The last quarter of the nineteenth century witnessed a continuous fall in the value of the silver bullion as one after another European country adopted the gold standard and also due to the discovery of new silver mines. [7] India being on the silver standard attracted the depreciating metal to the point of surfeit. While this brought the interest rates to a low level, it adversely affected the exchange rate. The continuous fall in the exchange rate not only affected trade and discouraged inflow of capital but also caused a direct loss to the Government in meeting their sterling obligations. A Committee, appointed to consider the situation, recommended the closing of the mints to further coinage of the silver-ruppee in 1893, with a view to introducing the gold standard in due course. This set afoot a great controversy as to the desirability and practicability of establishing the gold standard with gold currency in the country.

With the closing of the mints and the discontinuance of the silver imports the last element imparting elasticity to

5 Evidence before the Indian Currency Commission of 1898.

6 This is evident from the chart submitted to the Fowller Committee in 1893 and appeared in the Appendices to the Report. A large proportion of the imported silver found its way to the mints.

7 H.Stanley Jevons, Money, Banking and Exchange in India, Ch. X.

the Indian currency disappeared. In the following years there was an overall tightness in the money market and in the busy season of 1893 the minimum rate of the Bank of Bengal was as high as 12 %. The Fowller Committee, which was appointed in the same year, was primarily concerned with the immediate problems of exchange rate stability rather than with banking needs of the Indian trade and commerce. To them, once the variations in the exchange rates were evened out then the discount rate would take care of itself. Prof. Marshall, who also gave evidence before the Committee, was the only one to suggest that variations in the discount rates were a separate problem demanding a separate solution. [8]

The Fowller Committee, with exchange rate stability in mind, declared themselves in favour of the gold standard with gold currency in the country based on the principle of free inflow and outflow of gold. The cry for a central bank revived with the decision of the Fowller Committee. While the gold standard was conceived as an automatic mechanism to correct internal and external disequilibria, a central bank came to be regarded as a pre-requisite to the successful functioning of the gold standard. Mr. Hambro, who was a member of the Fowller Committee, said, "the success of the recommendations of the Committee will very much depend on the banking wants of the country being assisted in times of pressure, and curtailed in times of slackness ; and this could be done by the establishment of some institution having ample facilities at its disposal and framed on somewhat similar lines to those of either the Bank of England or the Bank of France." [9] He further pointed out that with the preference of the people for coins and the lack of deposit banking habit a central bank would have to have large capital and ample facilities at its disposal to prevent excessive

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[8] The Report of the Fowler Committee, Evidences, Qns. 11776 and 11852.

[9] E.A. Hambro's Minority Report attached with the Fowler Committee Report, 1898.

fluctuations in the short-term discount rates. The Government of India accordingly suggested that the three Presidency Banks should be amalgamated to form a State Bank rather than establishing a fresh institution for the purpose. [10] But the project was smothered in the magnificient and empty maxims of political wisdom. [11]

In reference to the actual recommendations of the Fowller Committee, the backwardness of the banking system, the predominance of coins in the total money supply and the lack of cooperation hindered the possibility of introducing the gold standard with gold currency in the country. In 1898, a gold standard without visible gold currency seemed undesirable and even an impossibility inspite of the earlier writings of Ricardo and Marshall and recent evidence of Mr. A.M. Lindsay [12] before the Fowller Committee. While the Government of India debated the question, the Indian currency unwittingly and imperceptibly passed on to the gold exchange standard. [13] This, no doubt, had the effect of shifting the emphasis back from problems of exchange stability to those of national currency and banking.

The perennial problem of Indian currency and finance, that is, how best to impart long-term and short-term elasticity into the system, reappeared in the following years with greater intensity. The Act of 1898, which authorised the issue of notes in India at the same rate against gold deposited in London and

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[10] Government of India Dispatch, August 24, 1899.

[11] Paper relating to the Establishment of a Central Bank, published by the Government of India, 1913.

[12] Mr. Lindsay, the Deputy Secretary of the Bank of Bengal always maintained that "they must adopt my scheme (i.e. gold exchange standard) despite themselves." J.M. Keynes, po.cit. P. 34

[13] The sterling value of the ruppee was fixed at 1 s. 4 d.

ear-marked at the Bank of England as part of the Paper Currency Reserve proved insufficient to even out the seasonal variations in discount rates. "If there would have been some authority which create money in India during the busy season," wrote Keynes in 1913, "it would not be necessary for the discount rate to rise so high." [14] He further wrote that "the Government have taken over so many functions of a central bank that they cannot wisely neglect the rest," [15] The arguments in favour of a central bank in the country was very strong -far stronger than in 1867 or even 1898- with the great expansion of paper currency and growth of credit during the preceding decade.

There was a change in the "climate" of opinion which was illustrated by the evidence given before the Chamberlain Commission of 1913. A central bank, for the first time, came to be regarded as necessary to break the unnatural dissociation of currency from banking, to provide elasticity in the system and to even out fluctuations in the short-term discount rates and in the Treasury balances, and to make proper use of the liquid resources of the Treasury. It was also realised that in the absence of a central banking authority there could not be any proper banking policy in the country. "The fatal defect of the Indian banking" said Sir Hamilton, "is that it maked no provision for the financing of the great industry Agriculture. The gigantic industry has been left to the mercy of small moneylending capitalists... It is the organisation of its capital that India wants more than its increase. There is plenty of capital in the country but it is mainly in the wrong hands... That is the great problem to which a State Bank should address

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[14] J.M. Keynes, op. cot. P. 54.

[15] J.M. Keynes, op. cit. 235.

itself... in one way or another, a bridge must be built by which the producer can reach the cheap money market." [16] Keynes, who was also a member of the Chamberlain Commission, went as far as to prepare a detailed draft constitution of a central bank on the lines of the Banque de France and submitted it before the Commission.

The Commission suggested in its Report that the problem of creation of a central bank in India deserved early and careful consideration and added that it was closely related to the expansion of agricultural credit through cooperatives, improvement of banking facilities and encouragement of sound banking in the country. The Commission was hesitant to recommend immedialely the formation of a central bank without visiting India and making an on-the-spot study of the problem. But before they could do so, the First World War broke out and the proposal for establishing a central bank was abandoned until the fresh problems of monetary management and banking organisation emerged to help reconstruct the wartorn economies of different countries, including India.

THE RISE OF THE IMPERIAL OF INDIA ; An experiment in Semi-Central banking

After the World War I there was a strong urge for quick return to "normal" conditions, but in addition, the experiences of the war had hastened progress in the direction of a unified monetary control. On the one hand, the war had brought together the Government and the three Presidency Banks and there was also increased cooperations among the Presidency Banks themselves. On the other hand, the war amply demonstrated the extent of India's dependence for industrial products on the countries

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16 Sir Daniel Hamilton's Memorandum to the Chamberlain Commission, 1913.

with which she had traded in the pre-war days and from which she was now cut off. This strengthened a growing demand for the industrialisation of the country. An Industrial Commission was set up which referred to the throughly unorganised state of the Indian capital market and the credit system, which were too inelastic to meet the genuine needs of trade, commerce and industry, and pointed out that the lack of financial facilities was holding back the industrial development of India. [17] Thus, the task of organising and developing the banking system and financial structure of the country for the sake of internal economic development received recognition almost for the first time.

Against this background emerged the Imperial Banf of India after the amalgamation of the Presidency Banks in 1921. The Bank was recongnised, from the very beginning, as a semi-public institution with certain measures of control by the Government. It became banker to the Government and holder of the Treasury balances. After the central banking traditions the Bank was expected to act as a banker's bank, holding their cash balances, rediscounting their bills and assisting them in times of crisis as the lender of the last resort. At the same time, the Imperial Bank was permitted to retain its commercial banking business which it inherited from its predicessor. The framers of the Imperial Bank went further and made it a pre-condition that the Bank should open one hundred branches within the first five year in order to further the banking development of the country. The Bank was, thus, established to represent in itself a peculiar blend of central and commercial banking like some of the State banks of Europe, There was, however, exceptions, viz. the Bank was not allowed to deal in foreign exchange and it was not given the power to issue notes. The constitution of the Imperial Bank was, observed by K.N. Raj, to be "a conscious experiment in the application of central banking principles to a country which had yet to make so much headway in the organisation of credit." [18]

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[17] The Report of the Industrial Commission, 1918, pp. 170-178.

[18] K.N. Raj, Monetary Policy of the Reserve Bank of India, P. 55.

Though not the first, the Imperial Bank was the most important, one pregnant with many possibilities. With increased resources and the Government behind it, at one time it was thought that the Bank might develop into a fully fledged central bank. But that was not to be so, and the unchallenged supremacy of the Imperial Bank did not last more than five years. But 1927 there were plans for a separate central banking institution and it was clear that the Bank would lose its privileged position among the other commercial banks. Even in the period 1922-27 the Bank was not given a completely free hand since the Government was at that time pursuing a deflationary policy through its management of currency and through its operations in the exchange market. The chief gain was the "pioneer" branches which together with an increase in the branches of the other banks added a greater degree of mobility of funds within the country. Another significant change was the disappearance of the Independent Treasury system. Previously, the Treasury had tended to demand funds just when those funds were urgently required for the busy season and had released them in the slacks season. But with the transfer of Government balances to the Imperial Bank, the latter was able to offset, at least to some extent, the vagaries of Treasury demand and to avoid extreme fluctuations in the short-term discount rates.

But the Imperial Bank could not provide an adequate solution to the problem of currency inelasticity and seasonal stringency to which it owed its origin. The issue of notes was subject to the restrictive provisions of the Paper Currency Act of 1920 and the provisions to meet the seasonal pressure for funds were such that it was almost inoperative. To meet the requirements of the busy season the Controller of Currency was authorised to issue notes up to Rs. 5 crores against inland bills of exchange maturing within ninety days ; and the additional issue took the form of a loan to the Imperial Bank at an annual interest rate of 8 %. The logical outcome of this was that no assistance would be given until the Bank Rate of the Imperial Bank exceeded 8 %. Later the minimum rate of interest was reduced to 6 % and the maximum amount of note-issue was raised to Rs. 12 crores. But these arrangements were of little help because

they did not recognise the "hundi" which is an important instrument of credit in India but not a bill of exchange in the proper sense of the term. Consequently, there was not a sufficient supply of inland trade bills to take advantage of the provisions for seasonal currency expansion.

Initially, the Imperial Bank operated successfully as a banker's bank, holding their balances and even giving assistance to them. But the Bank failed in its mission to develop a credit policy ; it neither encouraged the Government to develop a currency policy suitable to the need of the economy, not did it introduce any techniques of monetary management. There was an inherent conflict between its commercial banking business and public service and because there was no provision to restrict its profits, when the Bank was faced with a direct choice between private and public interests, there was a tendency to sacrifice the latter. The Imperial Bank competed heavily with the Indian joint-stock banks, the Bank's overdrafts and cash credits increased from 43 % in 1920 to more than 60 % within a few years while bills discounted and purchased declined from 20 % to less than 10 % in the same period. The Indian joint-stock banks, probably out of their false sence of pride, were averse to going to a competitor for help and found other means of guaranting their liquidity. While giving evidence before the Hilton-Young-Commission, Mr. A. Bowie observed, "Placed above economic competition by virtue of its character as a quasi-state Bank, it has begun to compete with the indigenous joint-stock banks, that have been left powerless to withstand this com petition." [19]

Moreover, the sense of responsibility of the Imperial Bank appeared to have fallen short of just those requirements which were of vital importance for an underdeveloped country like India. The Bank was inclined to neglect the importance of deve-

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[19] Hilton-Young Commission Report, P. 93.

loping ancillary credit institutions and it was positively obstructive in its attitude towards the exten ion of cooperative banking. [20]

Finally, the Bank was under foreign management and closely associated with other foreign interests, and in an era of surging sentiments of nationalism the Bank, rightly or wrongly, acquired a reputation of being anti-Indian ; and the Imperial Bank came to be identified as another instrument of imperialistic exploitation. This was the last blow to the acceptance of the Imperial Bank's leadership as a national bank. [21]

ATTEMPTS AT ESTABLISHING THE RESERVE BANK OF INDIA

The Imperial Bank's failings and shortcomings roused a common sentiment in favour of its dethronement from its privileged position and the establishment of an independent central bank without commercial banking functions. Attention was shifted from rapid expansion of banking to the creation of a discount market, as in Britain, for the distribution of financial assistance from the central bank and to the creation of machinery for the dissemination of credit facilities in response to any healthy growth in creditworthy demand. During this period international factors were also favorable to the development of central banking throughout the world. [22] It was in keeping with the internal need and international atmosphere that the Hilton-Young Commission of 1926 strongly recommended the establishment of a Reserve Bank in the country. The Commission discovered, though

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[20] Central Banking Enquiry Commission Report, 1931, P. 145

[21] J.S.G. Wilson, "The Rise of Central Banking in India" R.S. Sayers (Ed.) Banking in the British Commonwealth, 1952.

[22] To prevent a recurrence of monetary chaos such as followed the World War I, the international financial conferences at Brussels in 1920 and at Genoa in 1922 passed resolutions advocating the establishment of a central bank in countries which lacked them.

it was nothing new to the Indian people, the "inherent weakness of a system in which the control of currency and credit is in the hands of two distinct authorities whose policies may be widely divergent and in which the currency and banking reserve are controlled and managed separately from one another." [23] The Commission rejected the proposal to transform the Imperial Bank into a central bank as a matter of principle because they could not agree with the idea of central and commercial banking functions vested in the same institution. Therefore, they elaborated a scheme for a new central bank to be known as the Reserve Bank of India. The Commission also made recommendations for stabilising the exchange value of the rupee at 1 s. 6 d. (in the place of Rs. 1 = 1 s. 4 d.) sterling and linked the establishment of the proposed central bank to the maintenance of new over-valued exchange rate.

In faithful compliance with the recommendations of the Hilton-Young Commission the Gold Standard and The Reserve Bank of India Bill was introduced in the Legislative Assembly in January 1927 by the Finance Member Sir Basil Blackett. In the Bill, the Bank was envisaged as a shareholders' bank, free from political pressure and the majority of the Board of Directors to be elected from the shareholders and the Governor and the Deputy Governor to be nominated by the Governor-General-in-Council.

Indian public opinion was in favour of a central bank, but its linking with the overvalued exchange rate roused suspicion and the Nationalist faction in the Legislative Assembly demanded that the Reserve Bank should be a national institution subject to control of the representative political Assembly rather than a private shareholders' bank dominated by vested interests from within and without. In the Committee stage of the Bill it

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[23] Hilton-Young Commission Report, 1926, Para, 83.

was further proposed that the capital of the Bank should be provided by the state and the majority on the Board should be Indians including either the Governor or the Deputy Governor. These changes were suggested because at that time in India the Executive was not responsible to the Legislature ; "Free from political pressure" meant one thing to the Government and another to the elected members of the Assembly and each wanted to keep the other out. The Government of India could not agree with the proposed changes in the Bill and insisted on a shareholders' bank and a Directorate satisfactory to itself. After a year of heated controversy in the Assembly the Reserve Bank bill was withdrawn in February 1928.

The issue was brought up again at the Round Table Conference which was held in London in 1931 to decide the future political constitution of India. At the end of the Third Round Table Conference the transfer of the Finance Department to a minister responsible to the Federal Legislature was decided and the successful institution and functioning of the Reserve Bank was made a pre-requisite to the federal structure of India.[24] This coincided with the appearance of the Central Banking Enquiry Committee Report which strongly emphasised the early establishment of a Reserve Bank. In the same year, Great Britain left the gold standard and the world was passing through a severe depression. The British political and economic circles urged for greater economic cooperation between different parts of the Empire whose economies were complementary. They were also convinced that the existence of a chain of Empire central banks would promote closer economic cooperation with the "mother" country. The surging spirit or nationalism in India was also clamouring of a central bank that would help economic recovery

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[24] The Second Report of Federal Structure Committe described the Reserve Bank as "a fundamental condition of the success of the constitution." The Parliamentary Joint Committee on the Indian Constitutional Reforms also expressed similar opinion. Central Banking Enquiry Committee Report, 1931. Para 390 and 391.

of the country. Thus, in the years of great depression the nationalist and imperialist interests coincided. [25] As a result, there was a firm decision to establish a central bank in India as soon as the conditions were favourable.

In 1931, there was a slump in agricultural prices and India, being an agricultural country, was severely affected. This also upset the budget of the Government and adversely affected India's balance of payments. It was suggested that before the Reserve Bank was established the budget of the Government should be balanced, its short-term debt reduced and that the export surplus of India should habe recovered to its normal level. [26] These conditions were largely satisfied by 1933. The Government of India introduced a fresh Reserve Bank Bill in September 1933 in the Legislative assembly and the Bill was passed into law in March 1934. The passing of the Reserve Bank of India Act opened a new era in the monetary and banking spheres of India. It took a year to organise and the Bank started functioning in April 1935.

CONSTITUTIONAL STRUCTURE AND STATUTORY FUNCTIONS OF THE RESERVE BANK OF INDIA

With a view to understanding the monetary policy of the Reserve Bank of India it is necessary to have an idea of the constitutional frame work within which the Bank was originally set up to function. It will be seen here also in subsequent chapters that the Bank deviated from its constitutional path in order to fulfill its responsibilities as a central bank in an underdeveloped country like India, but the original constitution left its mark on all its actions. This section reviews the constitutional structure and functions of the Reserve Bank.

Constitutional Structure of the Reserve Bank of India

The Reserve Bank of India was originally set up as a

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[25] N.J. Almanla, Operations of the Reserve Bank of India, P. 52.
[26] K.N. Raj, op. cit. P. 66.

private shareholders' bank with a paid-up capital of Rs. 5 crores. In order to compromise with the nationalistic feelings of that time and to emphasize the "public" character of the Bank the Government of India contributed Rs. 220,000 to the share capital. The Government also transferred Rs. 5 crores worth of rupee securities to the Reserve Bank from its funds. However, following the nationalization of the Reserve Bank in 1949, the Government of India became the sole owner of all the shares of the Bank.

The general control and direction of the affairs of the Reserve Bank on India was entrusted to a Board of Directors consisting of sixteen members, of which the Central Government nominated seven directors, including the Governor and the two Deputy Governors. Other eight directors were elected by the five Local Boards ; and the Local Boards each consisting of five directors were elected by the shareholders of each area. Since the nationalization of the Reserve Bank its management has been assumed by the Government of India, and the Central Board consisting of eleven members and the Governor and the two Deputy Governors are all nominated by the Government of India. Members of the four Local Boards are also nominated by the Government of India representing territorial and economic as well as the interests of the cooperatives and indigenous banks. [27]

Following the practice of the Bank of England the Reserve Bank of India was originally divided into two departments :

1) the Issue Department being solely concerned with the issue of bank notes in India
2) the Banking Department, being engaged in the banking business.

These two departments are kept separate and wholly distinct from one another. The assets of the Issue Department which form the

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[27] Rangoon Local Board ceased to exist since Burma became an independent state.

backing for the note issue are kept separately from the Banking Department. In practice, however, such distinctions have little significance. Since 1935 the Reserve Bank has added several other departments in keeping with the growing needs of the economy. These departments are :

1) Agricultural Credit Department
2) Department of Banking Development
3) Exchange Control Department
4) Industrial Finance Department
5) Department of Banking Operations
6) Inspection Department
7) Economic Department
8) Department of Statistics

Statutory Function of the Reserve Bank of India

The Reserve Bank of India was constituted "to regulate the issue of Bank notes and the keeping of reserves with a view to securing stability in India and generally to operate currency and credit system of the country to its advantage". [28] This is more like an objective or goal rather than functions. In order to achieve these objectives the Reserve Bank has been entrusted with certain specific functions usually possessed by the central banks, and the authority to perform these functions has been derieved from the Reserve Bank of India Act, 1934 and from the Banking Companies Act of 1949. In its capacity as a central bank the Reserve Bank of India has been assigned with four specific functions. These are :

a) supply of legal tender currency
b) control of credit and the business of the banking
c) maintenance of the external value of rupee
d) acting as a banker, agent and adviser to the Government.

a) Supply of Legal Tender Currency

The Reserve Bank of India has the sole right under Section 22 of the Act of 1934 to issue bank-notes in India. It is

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[28] Preamble to the Reserve Bank of India Act, 1934.

an accepted principle of central banking that in the interest of monetary stability the issue of currency should be regulated by the central banking authority which is not guided by the profit motive. The monopoly of note issue is intended to give the Reserve bank complete control of the volume of cash and therefore, of credit in the country.

The method of note issue by the Reserve Bank was originally based on the proportional reserve system as against the fixed fiduciary system of the precentral banking era. The assets of the Issue Department consist of gold coins, gold bullion, and sterling securities, [29] rupee coins and rupee securities. Of the total assets not less than 40 % must, under law, consist of gold coins and bullion and sterling securities, provided that the amount of gold coins and bullion in not at any time less than Rs. 40 crores in value. Note issue could be increased or decreased at the ratio of 5 to 2 when the assets in the Issue Department rose of fell.

The proportional reserve system of note issue remained unchanged for nearly twenty years. The general trend in central banking legislation during and after the World War II has been to free the function of note issue from the reserve conditions. It is now recognised that the main purpose of gold and foreign exchange reserves is to enable a country to pay for its imports in the fact of declining exports, e.e. to tide over unfavourable swings in its balance of payments. In India the rapid progress of the economic activities under the development plans and the decline of non-monetized sectors have called for a larger expansion of currency. To meet these demands and to provide needed flexibility in the note issue the method of note issue was changed to the mimimum reserve system.

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[29] Sterling securities have been replaced by foreign securities in 1947.

In October 1956, the Reserve Bank of India was authorised [30] to issue notes on the basis of a minimum reserve of Rs. 400 crores in foreign securities and a minimum of Rs. 115 crores in gold coin and gold bullion. These provisions were further relaxed in November 1957 [31] whereby the aggregate value of gold coin and bullion and foreign securities should not be less that Rs. 200 crores, of which the value of gold coin and bullion should not be less than Rs. 115 crores.

b) Control of Credit and Banking Companies

The control of credit is generally accepted as the main functions of a central bank. For this the Reserve Bank is armed with all the traditional weapons of credit control possessed by the central banks on the advanced countries. It is through its Banking Department the Reserve Bank regulates the cost, availability and volume of credit. The Bank is authorised to publish its bank Rate and change it from time to time for the purpose of credit regulation in the country. The Bank is empowered to undertake open market operations in Government securities. It is allowed to rediscount bills of exchange, buy and sell securities, grant loans and advances against approved securities to the banks included in the Second Schedule of the Act, usually known as scheduled banks. The Bank is empowered to hold, free of interest , a minimum reserve of 5 % against deposit liabilities and 2 % against time liabilities of the schedule banks. Since 1956, these ratios could be increased to 20 % and 8 % against demand and time liabilities respectively. [32] The object of keeping such reserve is to ensure a supply of fund which would enable it to act as the efficient lender of the last resort but more particularly to give the Bank some measure of control over the credit policy of the member banks.

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[30] The Reserve Bank of India (Amendment) Act, 1956.
[31] The Reserve Bank of India (Amendment) Act, 1957.
[32] The Reserve Bank of India (Amendment) Act, 1956.

Apart from these general methods of credit control, the Banking Companies Act of 1949 has granted the Bank comprehensive power over the banking companies. The Bank is empowered to issue directives to the Banking companies in general of to a group of banks or to a particular bank regarding policies to be persued in relation to advances ; the purpose for which advances may or may not be granted ; the margins to be maintained in respect of secured advances and the structure of interest rates to be followed. The Bank has also the right to ask for additional information from the Banking companies.

To enable the Reserve Bank to control the banking bunisess generally, it has been granted to issue or withhold licences to the banking companies and to control their mergers, amalgamations and liquidations. The Bank conducts annual inspection of the banking companies to ensure that the banking business in India is carried on sound lines. In additions it has power of guidence over the cooperative credit system and other financial institutions.

c) Maintenance of the External Value of Rupee

The Reserve Bank of India is under obligation to maintain the external value of the rupee,and the rupee -sterling rate was fixed at Rs. 1 = 1 s. 6 d. in 1927 at the recommendation of the Hilton-Young Commission. However, as a natural consequence of India's becoming member of the International Monetary Fund the continuation of a direct statutory link of the rupee with the sterling, which was provided for by the sections 40 and 41 of the Reserve Bank of India Act became both unnecessary and inappropriate. Consequently, these two sections were repealed and replaced by one another designed to link the rupee to the currencies of all those countries who are members

of the International Monetary Fund. [33]

d) Banker, Agent and Adviser to the Government

Another statutory obligation of the Reserve Bank of India is to act as a banker, agent and adviser to the Central and State Governments, The Bank accepts money on behalf of the Central and State Governments and transacts their exchange remittances and other banking operations, including the management of public debt. The Bank was designed to act as a financial adviser to the Government and has the right to offer disinterested advice on all important financial matters so that it could mould the policy of the Government itself. [34]

With the task of economic development assuming a new urgency and importance, the range of functions of the Reserve Bank of India has steadily enlarged. After a humble beginning as a central bank of the orthodox line it now performs a variety of development functions. In the past these activities were regarded as being outside the normal scope of central banking. The Bank's responsibilities include, in addition to the traditional functions, the development of an adequate and sound

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[33] Under the I.M.F. Agreement the par value of the rupee was fixed in December 1946 at Rs. 1 = 30.225 U.S. cents or 1 £ = Rs. 3.308. The rupee was devalued in September 1949 together with other currencies of the Commonwealth countries and the par value since then was Rs. 1 = 21 U.S.cents or 1 £ = Rs. 4.761. The rupee - sterling rate remained unaffected.

Following the devaluation of the rupee in June 1966 the par value now stands at Rs. 1 = 13 U.S. cents of 1 £ = Rs. 7.69.

[34] The relationship between the central bank and the government has been well described by Lord Montague Norman as "I look upon the Bank (Bank of England) as having the unique right to offer advice and to press such even to the point of nagging; but always, of course, subject to the supreme authority of the Government." Royal Commission on Indian Currency and Finance, Minutes of Evidence, Vol.V. Non-Parl. Qn. 14597.

banking system for catering to the needs of not only trade and commerce but also of agriculture and industry, the institutional arrangements for the financing of which are slow to develop. Although the expansion of facilities for the provision of agricultural credit has been a statutory duty of the Bank, progress has been striking only in recent years. The Reserve Bank has also taken initiative for the establishment of suitable institutional framework for canalization of credit to the industrial sector of the economy. Thus, the Bank's activities which are wide and varied represent the superimposition of new lines of activities on the traditional central banking functions.

CHAPTER IV

THE ROLE OF THE RESERVE BANK OF INDIA BEFORE AND DURING THE WAR

Any attempt to evaluate the role of the Reserve Bank of India before and during the Second World War has been made difficult in the absence of stated policies that the Bank desired to persue. Here, we have analysed the economic and financial policies of the Government of India and also the monetary situation and credit conditions. On the basis of consideration of all these relevant facts we have tried to deduce the role of the Reserve Bank of India and the significance of its operations for a period extending from the inauguration of the Bank in April 1935 till the end of the World War II.

During these years the Indian economy passed from the slow process of recovery out of the Great Depression to the highly inflationary situation during the war period. The general economic conditions during these two phases were so diametrically opposite to one another that they need to be treated separately. First, we shall analyse the economic and financial policies of the Government of India during the post-depression period, and then, we shall examine, in brief, the main features of the war finance and the role of the Reserve Bank of India. This is followed by a critical appreciation of the operations of the Reserve Bank and their effectiveness during the post depression and war periods.

ECONOMIC CONDITIONS DURING THE POST-DEPRESSION PERIOD

Before the Second World War economic policies of the Government of India had a few prominent features. The first and foremost of these was the maintenance of fixed exchange rates. The Government was anxious to effect the uninterrupted annual

flow of remmittances of Home Charges [1] from India to Britain and to safeguard the value of British credit and investment in India. We have already noted how India unwittingly came to be under the gold exchange standard, and whenever Great Britain went off the gold standard, the Indian rupee fell on the sterling exchange standard. The policy of fixed exchange rate combined with the over-valuation of the rupee in 1927 [2] set in motion contractionist forces even before the onslought of the Great Depression. There was continuous deterioration in income level, prices, Government revenues and foreign trade surpluses. [3]

The process through which the overvalued exchange rate was maintained was equally injurious to the economy. There was unlimited purchase and sell of sterling, both in India and in Great Britain, at fixed rates. Whenever the pressure on the exchange rate became unbearable it was saved by sudden and large changes in money supply in India by the export of gold, [4] thus sacrificing internal price stability at the altar of fixed exchange rates. The over-valuation of the rupee together with these policies caused undue contraction of the money supply in India, and thereby, had the effect of deepening the depression and retarded the return to recovery.

Other features of the economic policies of the Government of India was its philosophy of over-all economic and finan-

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[1] Home charges were payments from India to the British Government on Government account which includes the following items: the interest on sterling debt, anuities from railways and irrigation works, Army and Marine charges, Payments due in connection with the Civil Department in India, India Office expenses, pensions of the British employees etc. The charges varied from £ 30 to £ 50 millions per year.

[2] At the recommendation of the Hilton Young Commission the Government of India raised the rupee sterling exchange value from 1 sh 4 d = Rs. 1. to 1 sh 6 d = Rs. 1. This was violently opposed by the Indian public opinion.

[3] cf. Vera Anstey, Economic Development of India, chap. XVIII.

[4] From 1931 to 1940 gold worth of Rs. 375 crores was exported from India. Banking and Monetary Statistics of India, 1954 P. 983.

cial orthodoxy. India, being a primary producing country, suffered heavily during the years of depression. The Government of India did little towards the recovery of the economy and its policy was in glaring contrast to that pursued in Britain. On the fiscal side, the Government believed in the virtues of the balanced budget and adhered to it during the thirties. There was a marked absence of any policy of public works based on borrowing inspite of the advice given to the Government by the highest contemporary authority. [5] In fact, public borrowing was reduced to the minimum. [6] Any large public debt outstanding was looked upon by the Government as a sign of weekness and cheap money policy and therefore to be avoided.

The combined effect of all these was a heavy dose of deflation, so much so that between 1926 and 1939 one-third of the total notes and coins were withdrawn from circulation. [7] Such a policy was completely opposed to the contemporary policy persued in Britain ; it deepened the depression and retarded the process of recovery. In fact, India never came out of the depression and fully recovered at any time before the beginning of the War, although the slow upward journey towards recovery started in the early months of 1935.

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[5] For example, Prof. H.S. Jevons, who was teaching at the Allahabad University, recommended a new and positive fiscal policy for the Government of India. cf. Proceedings of the Indian Economic Association, 1923, pp. 446-7.

[6] Between 1918 and 1926 the average annual borrowings were Rs. 29 crores, and then the amount fell down to Rs. 15 crores per year. Not only that but a large portion of the borrowings were done in Britain and spent there too in one form or another including any deficiency in Home Charges. J.D. Sethi, Monetary Problems of an Underdeveloped Economy, p.114.

[7] Of the total estimated notes and coins of Rs. 400 crores circulating in 1926, the notes declined by Rs. 26 crores and coins by Rs. 117 crores by the end of March 1939. For a comparison Between the British and Indian monetary policies, see H.N. Pathak, Central Banking Techniques, pp. 6-10.

The Reserve Bank of India was established in such rigorous atmosphere of monetary deflation. The Bank had no authority to change the monetary standard, i.e. the rupee sterling link. Theoretically, the Bank had the right to advice the Government on all important financial matters, but, in practice, it remained completely under the control of the Treasury and carried out its dictates. The Bank failed to inspire confidence and remained a non-entity in the Indian money market.

WAR FINANCE AND THE ROLE OF THE RESERVE BANK OF INDIA

The war period, extending from the outbreak of the War in September 1939 till the end of the war in the middle of 1945, is crowded with economic, financial and military problems, and it is beyond the scope of the present study to analyse all these in details. Here, we shall briefly point out the nature of war finance and its consequences. In this context we shall examine the role of the Reserve Bank of India. During this period the Indian economy passed through two distinct phases : the first phase stretches from the beginning of the war to the entery of Japan and the United States into the war, in December 1941, and the second phase extends from there onwards till the end of the war. The first phase is characterised by moderate inflationary pressures as against the highly inflationary situation during the second phase of the war.

THE FIRST PHASE OF THE WAR

Evolution of the Cheap Money Policy:

With the dark clouds of the war gathering on the horizon the Government of India reached an agreement [8] with the British Government whereby it was decided that India should pay for her own defence and the British Government would pay for all the expences incurred by the Government of India in the interest of the wider Imperial strategy. The British Government

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[8] The agreement was based on the Report of the Chatfield Committee, 1939.

paid for the Indian rupee in sterling known as the "recoverable war expenditure of the Government of India". Such sterling payments were later converted into sterling securities and held by the Reserve Bank in its account at the Bank of England as backings for the currency issue to meet indefinite British, and afterwards Allied war expenditure in India. Under the Reserve Bank of India Act there was no limit to the holding of sterling securities against rupee notes.

Thus, by this pre-arrangement the Reserve Bank of India was deprived of its privilege to manage currency in relation to the internal requirements of the country. The extent of expenditure on behalf of the Government of Britain or the Allied Powers was decided outside India and was kept seperate from the budgetary resources of the Government of India and was financed out of straight currency expansion. A prolonged period of inflation was casting its shadow.

However, the Government of India issued orders under the Defence of India Rules authorising the Provincial Governments to fix prices of certain essential commodities and introduced some other controls. These controls which lasted until the middle of 1943 were confined to a few essentials of life or those which the Government needed for use in the war. Most of the agricultural products, except staple food stuffs, were left out and no control was adopted over the supply and distribution at that time. [9]

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9 P.C. Jain, India Builds Her War Economy, PP 190 - 200.

TABLE 5

CURRENCY EXPANSION AND PRICE INDEX

AUGUST 1939 to DECEMBER 1941

(In crores of rupees)

Quaterly Average of Friday Figures	Notes in circulation	Index of Note circulation 1939 - 100	Index of Whole Sale Prices August 1939 - 100
August 1939	169'9	100'0	100'0
September 1939	192'8	113'8	112'9
December 1939	225'5	133'1	138'9
March 1940	225'5	133'1	127'9
June 1940	234'3	138'3	110'3
September 1940	217'2	128'2	111'0
December 1940	228'6	134'9	114'4
March 1941	240'6	142'0	118'8
June 1941	258'8	152'0	132'8
September 1941	267'6	158'0	142'2
December 1941	314'5	185'7	140'8

Source : Banking and Monetary Statistics of India, Section 7, Table 25, and Annual Reports on Currency and Finance.

Currency expansion began right from September 1939 and within four months it increased by 33 %. This initiated a speculative boom followed by an increased demand for liquidity. There was a sharp rise in prices ; the index of wholesale prices rose from 100 in August to 138 in December 1939. At first the rise in prices was speculative and it outstripped currency expansion. This led some writers [10] to conclude that in the first four months

[10] For details, see D.K. Malhotra, History and Problems of Indian Currency, PP. 170 - 173.

the rise in prices was the cause of currency expansion and afterwards the process was reserved. However, when the speculative boom burst in January 1940 and prices fell, the currency was not reduced but increased still further because it depended not on internal factors but on the tempo of the war and the rate of accumulation of the recoverable war expenditure.

The Government of India did not make any declaration of its monetary policy until February 1940 when both the Finance Member and the Governor of the Reserve Bank set themselves against a cheap money policy. [11] A cheap money policy had a special appeal to the Indian businessmen, [12] who had suffered from the monetary contractions of the last two decades. But the Government refused to learn from the contemporary opinions of the highest authorities or from the technique of war finance developed by the British Treasury and the Bank of England, [13] and insisted on a dear money policy. Government security prices began to sag and declined further with the progressive detorio-

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[11] Report of the Governor of the Reserve Bank to the shareholders (hereafter referred as Governor's Report), February 1940, PP. 39-40. Similar views were expressed by the Finance Member in his budget speech, Budget, February 1940, PP. 20-22.

[12] Indian Finance, an influential financial weekly Journal from Calcutta, continuoulsy advocated (from July 8 to December 9, 1939) for "a cheap money policy as the foundation of national monetary policy."

[13] Keynes forcefully argued in three articles published in the Times in Autumn 1939 that the British Treasury could and should be able to raise their defence loans at a maximum interest of 2½ % with proper management of its public debt policy. These articles were later published as a pamphlet "How to Pay For the War", February 1940. Keynes's approach was ultimately accepted and supports were forthcoming from "The Economist" and from the economists like D.H. Robertson, H.D. Henderson, who joined the British Treasury. R.S. Sayers, Financial Policies, 1939 - 45. PP. 67 - 73.

ration in the war situation. The crucial fact was the impression given by the Treasury regarding the objective and borrowing policy, and the Government failed to realise that it is the low interest rates which impress the investors as the strength of the market.

Regarding loans the Government of India dit not come to the market before June 1940. In the meantime with the help of accumulated sterling due to large favourable trade balances and the British war expenditure in India the sterling debt was partially repatriated, and the Government issued exactly the same type of rupee securities. While the repatriation was a sensible policy, the method adopted was that of high rates. [14]

TABLE 6

SHORT-TERM MONEY RATES 1938-39 to 1945-46

(In percentages annual)

Year	Bank Rate	Treasury Bill Rate	Call Rate (Bombay)		Bazar Rate (Calcutta)		Imperial Bank Hundi Rate		3-months Deposit Rates		6 months Deposit Rates	
			H	L	H	L	H	L	H	L	H	L
1938-39	3	1'63	2¾	¼	7	6	3	3	2½	¼	2¼	1¼
1939-40	3	1'86	2¼	¼	7	6	3½	3	2½	1	2½	1
1940-41	3	0'89	1¾	¼	7	6	3½	3	2½	¾	2¼	1¼
1941-42	3	0'72	½	¼	7	6	3		1¼	¼	1¾	1
1942-43	3	0'87	¼	¼	7	6	3		1	½	1½	¾
1943-44	3	0'90	½	¼	7	6	3		¾	¼	1½	1
1944-45	3	0'49	½	¼	7	6	3		1	½	1¼	½
1945-46	3	0'39	¾	¼	7	6	3		1¼	½	1¼	½

Source : Annual Reports on Currency and Finance.

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[14] The rates of interest on these rupee counterparts varied from 3½ % to 4½ %.

Short-term rates such as call-money rates and the Treasury bill rates continued to be high till the end of 1940. However, since the beginning of 1941 a number of factors were working inexorably towards the conditions of a cheap money policy. First, there was the increasing use of short-term borrowing from banks in the form of Treasury bills since September 1939. Secondly, currency expanded rapidly as the war progressed, and thirdly, the collapse of the boom in December 1939, followed by a loss of export market in Europe and the reduction in the trade balance reduced the demand for money. An increased money supply with a falling demand created plethoric conditions in the money market which could not but exert downward pressure on the short-term rates, even if the Government did not like it. However, the Government realised the opportunity presented to it, and cautiously followed a cheap money policy. [15] The Reserve Bank actively supported the belated cheap money policy of the Government and extended its operations for the defence loans.

Indian export market continued to shrink as more and more countries came under Nazi occupation. To some extent, this was made up by the increased purchases in India by the British Government. Near the end of 1940 production and prices began to rise slowly, and on the whole, inflationary pressures were moderate. The general index of wholesale prices which rose to 139 within four months of the War in December 1939 fell to 110'3 by June 1940 after the bursting of the speculative boom. Prices started to rise again at the end of 1940 ; the index reached 140'8 by the end of the first phase of the war in December 1941. However, this phase of tolerable inflation came to an end as the war spread to the Far East and South East Asia when Japan and the United States declared war.

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[15] But at no time was the declaration of cheap money policy made, although such phrases as "in pursuance of cheap money" or "in the interest of cheap money" began to appear right from the beginning of 1941.

THE SECOND PHASE OF THE WAR

Currency Expansion and Inflation :

The entry of Japan and the United States in the war changed the whole character of the war for India. The spreading of the war to the Far East and South East Asia also meant an increased Allied expenditure, particularly American war expenditure in India, and consequent upon it, a far more rapid expansion of currency to provide rupee finance. Successive victories of Japan in the Far East and South East Asia not only meant loss of export market but it aslo meant the loss of imports of essential food stuffs particularly from Burma, on whom India depended heavily during the pre-war days. Along with this started a period of low elasticity of production at home which became negative by the middle of 1943. [16]

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16 Index of production

	1938-39	1939-40	1940-41	1941-42	1942-43
Agricultural Prod.	100	99	98	95	102
Industrial Prod.	100	110'3	114'2	123'2	125'5

	1943-44	1944-45	1945.46
Agricultural Prod.	106	101	94
Industrial Prod.	125'5	121'7	120'7

Source : The Eastern Economist , Annual Number, 1948.

TABLE 7

CURRENCY EXPANSION AND PRICE INDEX

December 1941 to March 1946

(In crores of rupees)

Quaterly Average of Friday Figures	Notes in circulation	Index of Notes in circulation August 1939 = 100	Index of wholesale Prices August 1939 = 100
December 1941	314'5	185'7	140'8
March 1942	381'7	225'3	145'6
June 1942	443'2	261'6	158'6
September 1942	493'0	291'0	165'8
December 1942	570'4	336'7	186'2
March 1943	643'6	379'9	219'8
June 1943	723'4	427'0	243'4
September 1943	759'7	448'5	240'7
December 1943	840'8	496'3	235'6
March 1944	882'5	521'0	233'5
June 1944	931'4	549'8	240'9
September 1944	941'3	557'7	242'6
December 1944	1009'6	596'0	250'0
March 1945	1084'9	642'8	248'1
June 1945	1137'0	671'1	241'3
September 1945	1141'9	674'1	243'6
December 1945	1210'9	714'8	247'9
March 1946	1218'0	719'5	254'2

Source : Banking and Monetary Statistics of India, Section 7 and the Annual Reports on Currency and Finance

The above table shows that the rapid expansion of currency began towards the end of the first phase of the war. The currency expansion was not restricted to the rate achieved in the first phase but was speeded up by colossal proportion. The

war time currency expansion was higher in India than some of the Allied countries [17] and the whole of this expansion was the result of war expenditure.

TABLE 8

DEFENCE EXPENDITURE IN INDIA

(In crores of rupees)

Year	On India's Account	Recoverable War Expenditure *
1938 - 39	46'18	"
1939 - 40	49'54	4'00
1940 - 41	73'61	53'00
1941 - 42	103'93	194'00
1942 - 43	267'13	325'48
1943 - 44	395'68	377'87
1944 - 45	458'32	410'84
1945 - 46	395'32	374'54
Total	1,743'71	1,739'73

* War expenditure incurred by the Government of India on behalf of the British Government and Allied Powers.

Source : Report on Currency and Finance, 1946-47, P. 65.

Table 9 shows that whereas the defence expenditure of India increased tremendously, the Allied expenditure increased even more. Indian defence expenditure rose from Rs. 46'2 crores in 1938-39 to Rs. 458'3 crores in 1944-45, and the total war time

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17 See League of Nations Monthly Bulletin of Statistics, January, 1946.

increase over the normal budget was Rs. 1,691'2 crores ; the Allied war expenditure in India increased from nothing in 1938-39 to Rs. 410'8 crores in 1944-45, the war-time total being Rs. 1,739'7 crores. [18] And while the Indian part of the expenditure was met out of taxation and borrowings the major portion of the Allied expenditure was met by simple currency expansion [19] against sterling securities. It is ironical that the rupee sterling link, which was introduced by the framers of the Reserve Bank of India Act as a safety-value against inflationary tendencies became the engine of currency expansion and inflation. [20]

Prices started shooting up from the end of the first phase ; index of wholesale prices rose form 140'8 in December 1941 to 243'4 by the middle of 1943. The redeeming feature of the first phase, i.e. increase in production and absorption of money for liquidity, were fast disappearing. Thus, a huge amount of purchasing power was put in the hands of the public unmatched by similar increases in available goods and services, A first rate inflationary crisis developed by the middle of 1943. From June 1942 to June 1943 prices rose by 6 % per month and black

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18 To this Rs. 41'66 crores were added in 1946-47 during the period of demobilization thereby bringing the total to Rs. 1,784'39 crores.

19 War-time deficits on the Government account amounted to Rs. 1,265'7 crores, which is very nearly equal to the amount of currency expansion. War-time currency expansion war Rs. 1,157'3 crores and the balance was met by the sale of gold in India. J.D. Sethi, op. cit. 140.

20 V.K.R.V. Rao has described the rupee-sterling link as "the villain of the piece as far as the issue of more Indian currency is concerned". War and Indian Economy, 1943, P. 116 and PP. 145-56. However, it must be admitted that the Government could have inflated the currency in some other means without the rupee-sterling link.

market prices were naturally much higher; and while the Government purchases were made at controlled prices [21] millions of people had to buy almost whole of their basic necessaries of life in the black market, and this meant starvation for the low income strata. This was furtner aggravated by the failure of monsoon, the elimination of imports, the huge requirement of food for the Indian forces and foreign forces in India and other purchases by foreign countries. [22] These factors together created the largest famine of this century. [23]

The Government of India at first denied the existence of inflation. The Finance Member observed in his budget speech that there was only "a temporary situation in which an increase in the volume of purchasing power impinges for a time on a stationary or diminishing volume of consumable goods ... there is not the remotest risk of inflation on the scale which occured in some of the countries which suffered utter defeat in the last war". [24] The industrialists also held the same views like the Government, they denied the existence of inflation and attributed the rise in price to the scarcity of commodities. [25] However, the Indian economists issued a Manifesto affirming the causal

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[22] This refers to the purchases made by the representative of the Middle Eastern Countries. B.R.Shenoy, the Sterling Assets of the Reserve Bank of India, P. 13.

[23] The Report of Bengal Famine Enquiry Commission puts the death figure at 1½ millions. The unofficial estimate varied between 3 to 4 millions. It is difficult to reconcile these figures, but it is certain that the death toll was very high indeed.

[24] Budget, 1943-44, February 1943, Paras 50 to 55.

[25] G.D. Birla, one of the top industrialists of India wrote a book then Inflation or Scarcity, in defence of his arguments. According to the President of the Indian Chamber of Commerce Mr. D. Khatiar, "the currency expansion is only an optical illusion ; actually it is the availability of goods that is dwindling and not the volume of currency that is expanding". The Eastern Economists, July 9, 1943.

relation between currency expansion and rise in prices. The Manifesto clearly established that the inflationary spiral was already at work and criticised the ruinous policy of "deficit-induced flat-money inflation" caused by the peculiar system of war finance. The authors of the Manifesto suggested the necessity of closing the "gap" by increased taxation and borrowings and also by the adoption of effective policies of price control, rationing and production under centralised supervision.[26]

Prompted by such pronouncement regarding inflationary purchases and influenced by the spot conditions of spiral rise in prices, the Government of India perforce realised the seriousness of the situation [27] and started taking measures like price control and rationing of the basic necessaries of life, special inventives to agriculture and strict measures against hoarders. But all these efforts could not reduce the rate of currency expansion as preparations were made for an all-out war in the Far East and South East Asia, nor could they bring about any rise in production because the structural rigidities in the economy. The Government measures to mop up newly created purchasing power throuhg loans and borrowings were very successful, but in relation to the magnititude of the problem they were grossly inadequate. The situation remained highly inflationary during 1944 and 1945, but the rate of rise in prices was slowed down because of the above mentioned steps taken by the Government.

In the first phase of the war the Reserve Bank had neither resources nor experience or even willingness to do much in the matter ; monetary policy was not even in the agenda to fight war-time inflation. However, in February 1941 the Reserve Bank of India Act was amended to remove the restrictions on the maximum amount of rupee securities which it could hold in

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[26] The Manifesto was issued on April 12, 1943, vide, C.N. Vakil, Financial burden of the war, PP. 134-9.

[27] The Budget Speech of the Finance Member is full of these realization: "We have all become conscious of the dangers of inflation, an awareness which has been hightened by the series of anti-inflationary measures which the Governments themselves launched". Governor's report also admitted the existence of inflation. August, 1943, PP. 46-47.

its Issue Department ; and during the first phase of the war the Bank gathered enough experience by trial and error. Once the physical control on the supply and distribution were in operations the Bank was equipped to play its role. But any policy of monetary stability by the Reserve Bank was rendered impotent because of the very method of war finance. The Allied military expenditures were outside the operations of the Government of India [23] or the Reserve Bank and the Bank remained a passive agent of currency inflation. However, the Bank was successful in raising all the defence loans at the lowest possible rates ever recorded. But the success was more due to the circumstances than its own achievement. We shall discuss this in detail in connection with the operations of the Reserve Bank.

Before leaving this section it is necessary to say a few words on the recoverable war expenditure and the sterling assets of the Reserve Bank of India acquired during the war. We have already noted the repatriation of the sterling debt of India by the Reserve Bank. Inspite of the huge repatriation of the programm for which sterling was utilized, the foreign assets, mainly sterling, of the Reserve Bank increased from Rs. 72 crores in August 1939 to Rs. 509 crores in March 1943. There was a campaign started by the British press at the end of 1942 against the accumulation of sterling and credit balance of India [29] and demands were made for the revision of the fianacial agreement of 1939 regarding the division of war ex-

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28 "If the Allied expenditure had been integrated with the Indian budget the same amount of inflationary finance would not have been there. The Government would have had to have greater recourse to the market". J.D. Sethi, op. cit. P. 142.

29 According to the New Chronicle the Financial Agreement of 1939 was "irrational and monstruously unfair to Britain" ; quoted in Capital, January 29. 1943. Also see R.S. Sayers, op. cit. PP. 258-66

penditure as they thought India's share was smaller. [30] To the Indian public such accumulation of sterling was linked with misery and privation within the country, and goods for goods was what they wanted. It was "not always perceived that the war time real burden of India was unaffected by the extent to which a post-war claim was registered against the United Kingdom." [31]

The revision of the financial agreement was avoided by the threat of resignation by the Indian members of the Viceroy's Executive Council and War Council. The total foreign assets of the Reserve Bank of India amounted to Rs. 1,724'3 crores at the end of March 1946. This was the result of sterling accumulation against the recoverable war expenditure and the substantial trade surplus minus sterling utilized for the repatriation of the sterling debt and Home charges. The British Government, inspite of its difficulties in the postwar period, agreed to meet them in full. Originally, such reserves were intended to be utilized for the future economic development of the country, but a significant portion of these reserves were spent on necessary and unnecessary imports before the beginning of planning in India.

OPERATIONS OF THE RESERVE BANK OF INDIA, 1935 - 1945

Following the practice of the Bank of England the Reserve Bank of India was equipped with two traditional instruments of monetary control, viz. the Bank rate and Open market operations. [32] The Bank was authorised to publish a

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[30] Mr. Winston Churchill also thought so ; cf. The Second World War, vol. IV, P. 181. To this Prof. Sayers replied "The immediate real burden of British, as of Indian, expenditure within India fell exclusively on India. No financial wizardry could protect the people of Hindustan from this burden." op. cit. PP. 271-2

[31] R.S. Sayers, op. cit. P. 259.

[32] Vide, Section 17 of the Reserve Bank of India Act, 1934.

discount rate and elaborate rules were laid down regarding the kind of papers that it would accept for rediscounting and for granting loans and advances. It was also authorised to purchase and sell securities in the market whenever necessary to bring about a desirable change in the credit situation. The Bank was empowered to hold, free of interest, a minimum reserve of 5 % against demand deposits and 2 % against time deposits. The Bank had no power until 1956 to change the reserve ratios, consequently the Bank relied on the first two methods of credit control although their inadequacy was apparent in view of the underdeveloped nature of the Indian money market and banking system. However, with the beginning of the planned economic development and the return of a flexible monetary policy through out the world in the early part of the fifties, these traditional instruments were supplemented by more direct methods of monetary control.

LOANS AND DISCOUNT OPERATIONS OF THE RESERVE BANK

Significance of Discount Policy

The rediscount policy was the first important method of monetary control to be developed by the central banks and at the turn of the century credit policy of the Bank of England could be interpreted primarily in terms of changes in its discount rate popularly known as the Bank rate. Bank rate changes have usually been made for a variety of purpose, of which the most important have been the desire to influence the foreign exchange market, and secondly, to cause changes in the rate of creation of credit, and through this, in the volume of investment, income and prices. Generally, the first step in the process of making the Bank rate effective lies through its effect on the short-term rates. Though it is not the end of the process, a central bank which can nake all other shrot-term rates follow its Bank rate may assume more than half of its task done.[33]

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[33] S.N.Sen, Central Banking in Underdeveloped Money Markets, P. 33.

A close connection between the Bank rate and short-term rates could be established by means of an active and well-developed money market depending on the central bank for accomodation to meet its marginal requirements and also in times of seasonal strains and intense business activities. Under such circumstances, rediscounting by the banks will be a regular practice, instead of being an occasional or emergency affair and will result in the establishment of sentitive connection between the Bank rate and the whole spectrum of short-term rates.

The growth of regular rediscounting by the banks at the central Bank pre-supposes three conditions, viz.

a) Banks do not possess any prejudice against rediscounting at the central bank ;
b) they keep an amount of cash reserves just sufficient for ordinary occasions ;
c) they possess in sufficient amount those instruments of credit which the central bank is willing or allowed to rediscount.

Here, we shall analyse how far these conditions were fulfilled in India in order to enable the Reserve Bank to make its discount rate policy effective.

Causes of Ineffectiveness of Rediscounting Policy in India

If banks possess any prejudice against rediscounting at the central bank, as in the London maney market, rediscounting habits may not grow at all. Banks in London have been able to avoid going to the central bank on account of the existence of the Discount market, with its ready access to the Bank of England. But the situation has been different in India. Till the establishement of the Reserve Bank, the only alternative source of funds to the banks was the Imperial Bank of India. Unfortunately, commercial banks had been inclined to look upon the Imperial Bank more as a rival and a competitor and they had a grivance against its privileged position. But banks in India expressed before the Central Banking Enquiry Committee, their

readiness to go to the proposed central bank whenever the need for rediscounting arose. [34] With the establishment of the Reserve Bank of India, it was hoped that the banks will approach it without any prejudice and will thus help in developing the discount market. But as we shall presently see the actual position unfolded an altogether different picture. This was not so much due to the prejudice of the banks to approach the Reserve Bank for rediscounting, as due to their self-sufficient position as to their resources and cash reserves.

Self-sufficiency of the Scheduled Banks

Growth of the rediscounting habit presupposes that banks follow the practice of operating with an amount of cash reserves which are just sufficient to meet their ordinary requirements, and lending or investing the remaining balances. As trade activities increase beyond the normal level and the demand for bank advances rises, banks will have either to sell some of their securities or rediscount bills (or borrow) at the central bank to meet this increased demand for accomodation. But in India, where the money market is not fully developed, banks were forced to keep larger cash reserves than was usual with the banks of the United Kingdom or the U.S.A. Growing up in an economy subject to great seasonal fluctuation, without a central bank to fall back upon in case of need, banks in India came naturally to depend on themselves for maintaining their liquidity and to keep sufficiently large cash reserves. They had to act as their own central bank and keep enough resources on hand for emergencies. Moreover, being dominantly an agricultural country. The banks found it difficult to secure sound proposals for investment of their funds during the off season. To that extent, they were forced not only to keep large cash balances, but they had to tolerate substantial fluctuations in their cash reserve ratios.

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[34] Minutes of evidence Central Banking Enquiry Committe Report India 1931.

TABLE 9

ASSETS AND LIABILITIES OF SCHEDULED BANKS IN INDIA, 1935 to 1945, IN CRORES OF RUPEES

Year	Liabilities		Total Liabilities	Cash at Hand and Balances with the Reserve Bank	Excess over minimum requirements	Percentage of 5 to 4	Advances	Inland bills discounted	Percentage of 9 to 4
	Demand	Time							
1	2	3	4	5	6	7	8	9	10
1935	117'89	97'78	215'67	36'29	22'41	16'8	87'56	3'42	1'5
1936	125'84	100'55	226'39	36'25	22'07	16'0	89'58	4'25	1'8
1937	135'04	108'74	243'78	31'96	16'55	13'1	113'13	6'34	2'6
1938	130'05	108'29	238'34	23'50	8'06	10'0	114'55	4'95	2'0
1939	135'51	106'07	241'58	22'94	7'16	9'4	118'82	5'43	2'6
1940	155'70	106'16	261'86	37'94	20'12	14'1	131'78	4'11	1'5
1941	200'15	107'08	307'23	47'38	25'74	15'4	118'83	4'96	1'6
1942	280'28	104'20	384'49	64'54	37'08	16'9	99'51	2'58	0'67
1943	419'41	131'03	550'44	78'70	36'67	14'2	137'51	4'32	0'78
1944	561'52	181'92	743'43	111'66	53'92	15'0	206'32	9'64	1'2
1945	631'81	240'33	872'13	119'47	50'84	13'0	269'04	14'67	1'7

Source : Banking and Monetary Statistics of India, P. 234, 1954.

The above table reveals the assets and liabilities structure of the scheduled banks in India during the post-depression and war period. During those years the scheduled banks in India maintained a very high and fluctuating cash reserve ratios. When the Reserve Bank was established, conditions were not favourable to the growth of the practice of rediscounting. The demand for bank advances was on a low level on account of the impact of the world trade depression, and during the war period, the scheduled banks experienced an unprecedented increase in deposits, but the channels of investment were limited. Consequently banks had enough cash balances and they did not feel any need to approach the Reserve Bank for rediscounting. However, on occasions the scheduled banks needed external assistance, but there the Reserve Bank was undercut by the Imperial Bank of India.

Rival Role of the Imperial Bank of India

The Imperial Bank of India, which missed the chance to be the central bank of the country, made an attempt to push the newly established central bank into the back ground, and with ample resources [35] successfully withheld other banks from approaching the Reserve Bank for loans and rediscounting. Even before the Reserve Bank published its first Bank rate, the Imperial Bank announced in June 1935 its scheme of granting loans against Government securities at 3½ %, which was reduced to 3 % a month later when the Reserve Bank declared the Bank rate at 3½ %. Imperial Bank was prepared to extend to commercial banks the benefit of secured advances at the call-money rate. These measures were taken by the Imperial Bank so that banks might not approach the central bank for rediscounting their

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35 The Reserve Bank of India, Banking and Monetary Statistics of India, 1954, Section 1.

trade bills at the Bank rate which was obviously higher by ½ %.

In November 1935 the Bank rate was reduced to 3 %, and the Imperial Bank reacted to it by announcing that it would grant loans and advances against Government securities, gold or silver bullion or against documents of title there to, at an interest known as the Imperial Bank advance rate of 2¾ %. Moreover, it agreed to charge interest only for the actual days the loans were outstanding, whereas the Reserve Bank's advances were only for a minimum period of seven days. Thus, the Imperial Bank succeeded in attracting borrowers who would have otherwise approached the Reserve Bank. The Imperial Bank acquired the leadership of the Call-money market, the most sensitive part of the money market and where most of the stockbrokers operated.[36] This caused the inter-bank call-money rate and other short-term rates to move more or less simultaneoully with the advance rate of the Imperial Bank. The principle of non-competition prevented the Reserve Bank from entering into the call-money market.

The net result of the policy of the Imperial bank was that it made the Bank rate a penal rate for all practical purposes and indirectly created a prejudice against the Reserve Bank. Its discount rate remained out of touch with the market rates and hence ineffective. The scheduled banks found it cheaper to borrow from the Imperial Bank and apply to the Reserve Bank only when the Imperial Bank could not accomodate any more market demand for funds. Such conflicts of policies between the two Banks were more prominent before the World War II.

Dearth of Rediscountable assets on the Portfolios of the Scheduled Banks

The third condition of the growth of rediscounting habit is that the banks possess in sufficient quantities those instruments of credit which the central bank is willing or authorised to accept. The Reserve Bank was set up on the orthodox model, it was authorised to rediscount only first class trade or commercial bills of exchange, drawn up to finance the movement of sale of goods with a maturity of not more than ninety days. In India indigenous trade bills - known as hundis were

not recognised by the Reserve Bank as an eligible asset for rediscounting. Consequently, there was a dearth of what were called eligible assets in the postfolios of banks. This point was highlighted by the banking crisis in June 1938.

In that month the Travancore National and Quilon Bank - a leading scheduled bank in South India closed its doors to the depositors after a big run upon it. The Bank approached the Reserve Bank for timely assistance against promissory note payable on demand. The Reserve Bank declined to accept those on the ground that they were not the usual eligible notes maturing within ninety days. The banks then produced as security the documents whereby goods were pledged to them, but interpretation put on these documents by the Reserve Bank mean an absolute refusal, because as the Bank explained, what was required was warehousekeeper's certificates and not mere title to goods, knowing fully well that warehouses were non-existent in India at that time. The Reserve Bank could have saved the bank by applying the emergency provisions [37] whereby the Bank can grant loans and advances against any security it may consider adequate and not insist on the form of securities as described by the Reserve Bank of India Act. The Reserve Bank did nothing of the sort. The attitude of the Reserve Bank was not only unrealistic, but contrary to the purpose of a central banking institution. The scheduled banks were reluctant thereafter to depend on the Reserve Bank and preferred to act as their own central bank and lender of the last resort by building up strongcash reserves.

However, this technical defect, i.e. lack of rediscountable assets disappeared during the war period when the

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[37] The Reserve Bank of India Act, 1934, Section 18.

scheduled banks acquired a large quantity of Treasury bills which were rediscountable at the Reserve Bank. Also, the percentage of holding of government securities increased considerable and the scheduled banks could borrow at the Reserve Bank against those securities.

Volume of Loans and Rediscount Operations of the Reserve Bank

The absence of regular rediscounting practice by the scheduled bank at the Reserve Bank were primarily due to the large cash reserves of the banks and lack of demand for bank advance. As we have seen, banks in India were in the habit of keeping excess cash reserves and during the thirties the demand for advances were low because of the onslought of the Great Depression the Keynesian fringe of unsatisfied borrowers were not there. These, together with the policy of the Imperial Bank of India created an atmosphere which were not favourable for the growth of loans and rediscounting practice at the Reserve Bank. During the Second World War deposits of the scheduled banks increased rapidly owing to the war finance and cheap money policy. Their cash reserve ratios also experienced a similar trend as there was a lack of demand for bank advance because of the excess liquidity of the economy and Government's control measures. Consequently, the scheduled bank's dependence on the Reserve Bank for accomodation was very slight. The following table reveals the low volume of loans and rediscounts operations of The Reserve Bank during the post-depression period and the war period.

TABLE 10

LOANS, ADVANCES AND DISCOUNTS OF THE RESERVE BANK : 1935 to 1946

(In crores of Rupees)

Year (average of Friday figures)	Loans and Advances to Government	to others	Bills purchased and discounted Internal bills	Treasury bills
April 1935	--	--	--	--
" 1936	7'90	'05	'01	--
" 1937	3'4	'01	'03	--
" 1938	3'65	'05	'01	'18
" 1939	11'64	1'04	--	10'33
" 1940	5'12	'30	--	10'95
" 1941	22'17	'19	--	4'54
" 1942	8'46	'21	--	1'77
" 1943	2'88	'05	--	2'81
" 1944	1'96	1'01	--	4'72
" 1945	2'39	'21	--	9'04
" 1946	'71	1'05	--	16'66

Source : Banking and Monetary Statistics of India,1954 PP. 598-630.

Loans, advances and discount figures of the Reserve Bank reveals that till 1939, the only regular customers of the Bank were the Central and Provincial Governments. Their borrowings followed a seasonal pattern, tending to increase in the busy months of October to May when the demand for money was active and falling off during the slack period of June to September. Loans and advances to others, i.e. to the scheduled and cooperative banks against government securities and usuance bills were negligible with the exception of the busy months of 1939-1940. During the war period banks borrowed small amounts from time to time.

The amount of internal bills purchased or discounted by the Reserve Bank was nil except in the busy months of 1936 and 1937, when the Bank discounted internal bills of very negligible amount. However, from 1938 onwards the Bank purchased and discounted Treasury bills of modest amount every year. The amounts outstanding in the portfolios of the Reserve Bank were never large except in the busy seasons of 1939 and 1940 and in 1945-46.

The low volume of loans, advances and discounts at the Reserve Bank suggests independence of the Banking system and a lack of strong link between the money market and the Reserve Bank. During the war-period the banks borrowed or discounted Treasury bills at the Reserve Bank more regularly than the post-depression period. This was an healthy sign towards the development of a normal connection the banking system and the Reserve Bank, But the smallness of the amount suggests that the Reserve Bank had slight influence over the banking system and money market.[38]

OPEN MARKET OPERATIONS OF THE RESERVE BANK

Scope of Operations :

In the absence of regular discounting by the commercial banks, the development of open market operations -the purchase or sale of assets by the central bank on its own initiative- as an additional, and to some extent, alternative instrument of monetary policy is a logical step which has taken place in the evolution of monetary management. The assets that are usually delt with may be bills, securities, bonds, gold and silver and foreign exchange. But since 1930 dealings in govern-

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[38] S.K. Muranjan, Modern Banking in India, p. 267.

ment securities and other gilt-edged securities, both long-term and short-term, have been undertaken by various central banks in such colossal amounts and so frequently that open market operations have, by practice, come to be confined to these referring to government securities only. A purchase or sale of securities by the central bank changes in the supply of funds in the money market and brings about desired changes in the money rates and credit conditions.

There are two ways in which open market operations may affect the money market. In the first place, these transactions add to or deduct from the supply of money in the market, and so increase of decrease the cash balances of the banks. This increase or decrease in the cash reserves, on which depends the credit-creating capacity of the commercial banks, tends still further to increase or decrease the volume of loans and advances. The Keynesian discussion on the modus operandi of open market operations in the second volume of the Treatise on Money runs entirely along the effects of such operations on the cash reserves of banks. Secondly, a purchase or sale of securities by the central bank affects, to some extent, the prices of government securities, and therefore influences long-term rates of interest. Thus, through these two effects the monetary authorities are able to introduce the desired adjustment in the domestic levels of prices, costs, production, trade and employment. While the policy of rediscounting brings about an indirect influence on money rates and credit through primary changes in short-term money rates and secondary repercussions on long-term interest rates of yields, open market policy of a central bank has a direct and immediat effect on the volume of money and credit as well as on money and interest rates.[39]

The Reserve Bank of India was empowered by the ori-

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[39] De Kock, Central Banking, P. 134.

ginal Act of 1934 to purchase and sell securities on its own initiative to bring about a desirable change in the credit conditions in the country. But in the earlier years there were quantitative and qualitative restrictions on the assets which the Reserve Bank was permitted to deal in or hold for its open market policy. For example, the Banking Department could not hold Indian securities to the value of more than the Reserve Bank's share capital, reserve fund and three-fifths of its liabilities in respect of deposits. Of these, the maximum allotted to the long-term securities was smaller, i.e. one-fifth than the maximum, i.e. two-fifths allotted to the short-term securities. [40] The Bank could not hold more than one-fourth of Indian securities. [41] These restriction on the volume and types of securities that the Reserve Bank could hold reduced the resources at the disposal of the Reserve Bank for conducting open market operations.

Moreover, the organisation and capacity of the market in which the Reserve Bank had to deal were far from satisfactory. Most of the operations initiated by the Reserve Bank were carried out in Bombay, Calcutta and Madras ; but these markets do not possess the large number of dealers, or the resources, or the variety of securities which exist in the highly organised markets of London and New York. The Indian security markets do not possess the capacity required for the completion of large deals within a reasonable period of time and without large fluctuations in security prices.

Another important condition for the effective use of open market operations as a monetary instrument is the stabili-

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[40] The Reserve Bank of India Act, 1934, Section 17 (8). This provision was omitted by Section 7 of the Act 32, 1951.

[41] This provision was omitted by Section 2 of the Ordinance 3, 1941 to meet the requirements of war-finance.

ty of the cash ratio of the commercial banks. If the cash ratio is stable the central bank can be reasonably certain of the effects of its open market operations on credit conditions. In India, scheduled banks maintain high and fluctuating cash ratios. In the early years of the Bank's existence the cash ratio of scheduled banks had varied between 21 % to 7 %. However, since 1951-52 the ratio varied between 11 % to 6,3 %. In India, therefore, the cash ratio, it would appear, is not so stable but the short-term variations are not so marked as the early years.

Thus, apart from the restrictions on the volume and quality of assets in which the Reserve Bank was entitled to operate, the underdeveloped nature of the money market, highly fluctuating cash ratios, the lack of clear-cut channels of communications between various sectors of the money market and the absence of a bill market till 1952 -all these deficiencies precluded the Reserve Bank from using open market operations as a sensitive instrument of control either on interest rates or over the reserves of scheduled banks. The only and most important sphere of operations left to the Reserve Bank was its authority to manage the public debt.

It may be argued that the loan operations of the Government both long and short terms, carried out by the Reserve Bank as an agent of the Government are not the same thing as buying and selling securities in the open market and do not affect the variations in the supply of money in the same manner. It is further said that open market operations undertaken by the Reserve Bank on its own account imply an expansion or contraction of its aggregate assets-structure and, therefore, of its total liabilities, but loan operations, when undertaken by the Bank on behalf of the Government causes only shifts of its liabilities from the public to the Government and vice versa.

In reply to this argument, it may be said that for every loan operations of the Government the Reserve Bank is confronted with the choice whether it will be subscribed to by

the Bank itself, in which case they will most certainly expand. Sometimes it happens that, in the absence of adequate reponse from the public to subscribe for the Government loans, the Reserve Bank has to make a direct loan to the Government either by the purchase of Treasury bills on "Tap" from it or through straight-forward loans. In many cases, the Reserve Bank takes up a good portion of new loans, but specifically for the purpose of re-sale to the market. Beside, the Reserve Bank being banker, financial adviser of the Government, has to decide whether a particular loan should be floated at a particular time, if so, on what terms and conditions and how much it should itself contribute. Further, a debt-operation of the Government can cause any one or all of these effects :

1) Shifts of cash-reserves from the banks to the Reserve Bank
2) changes in the holdings of non bank investors, which affects their cash reservss
3) Changes in bank-holdings of Government obligations which increase or decrease their deposit liabilities by equivalent amounts.

For all these reasons, the loan operations of the Government serve as powerful open market operations of the Reserve Bank. It is in this broad sense, and not only in the narrow and conventional sense of the purchase or sale of securities by the central bank on its account, that we shall analyse the open market policy of the Reserve Bank of India.

Nature and Extent of Operations before the War

The period preceding the World War II was marked by easy money conditions in general. But there were some months, espacially during the busy seasons when there were stringencies in the money market accompanied by rising call money rates and a fall in the gilt-edged prices. Under such circumstances, the Reserve Bank entered the market and purchased securities to easy the seasonal stringencies and this lead to an improvement in the Government security prices. The Bank also purchased securities to create favourable conditions for the floatation of new loans. Volume of purchases were not large as the invest-

ment of the Bank fluctuated between Rs. 5 crores to Rs. 9 crores during the post-depression period.

From March 1938 the international political situation depress the giltedged market repeatedly. There was also a disparity in prices between the Indian rupee securities and the Indian sterling loans, which resulted in many investors selling their rupee securities and buying sterling ones in their place. Fluctuations in Government security prices were, therefore large and frequent. The Reserve Bank's purchases helped to iron-out such fluctuations. A further fillip to the gilt-edged market was injected by obligations placed on the insurance companies operating in India, as from July 1938, to hold rupee securities equal to 25 % of their total liabilities in India. Some degree of stability in security prices was achieved by August 1939, but the market collapsed with the outbreak of the War in September 1939.

Thus, before the Second World War, the open market operations of the Reserve Bank in the form of purchase and sell of securities were on a very moderate scale. Whatever transactions were undertaken by the Bank in Government securities, their chief purposes were relieving seasonal stringencies, creating favourable conditions for the issue of new loans and the maintenance of orderly conditions in the gilt-edged market. [42] However, seasonal stringencies almost disappeared during the war period because of the excess liquidity in the economy as a result of the war finance. It was the second objective, i.e. preparation of the market for the flotation of new loans became the paramount objective and for that, stabilization of the gilt-edged market and a low interest structure were essential.

FLOTATION OF WAR LOANS BY THE RESERVE BANK

At the beginning of the war, the borrowing programme

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[42] K.N. Raj, op. cit. P. 105.

of the Government of India fell short of those essential requirements. This was partly due to the meagre resources and inexperience of the Reserve Bank and partly due to the indifference of the Government and its aversion to a cheap money policy.

The first important step which should have been taken was to make a firm statement of its borrowing policy as was done in Great Britain by Sir Simon of the British Treasury. [43] The crucial factor, as stated by Keynes, was the impression made by the Treasury on the market. [45] Secondly, the Government should have developed appropriate techniques of such borrowings suitable to the occasion from the very beginning. The direct intervention in the form of fixing security prices was always regarded as being legitimate in an emergency like war. It was all the more important in India because the markets were not properly organised but were at the mercy of reckless spectulators. The Government should have supported the market at fixed prices or by fixing upper and lower limits of security prices of all kinds right from the outbreak of the war and within which alone dealings could take place. Measures along these lines were taken after considerable delay.

The gilt-edged market was steady two months before the outbreak of the war. It started sagging with the clouds of war gathering on the horizon but the market collapsed after the declaration of the war in September 1939. The 3½ % undated Rupee Paper which stood at Rs. 98.4.0 in early August fell to Rs. 86.22.0 by the end of September and came down to Rs. 80.7.0. a month later. While the boom was in full swing in the stock and share markets. The gilt-edged market gathered strength only after the collapse of the boom at the end of December 1939.

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43 R.S. Sayers, op. cit. Chapter V.

44 Keynes, How to Pay for the War, P. 146-62.

This was not so much due to the intervention of the Reserve Bank but more due to the pressure of newly created money and switching from commodities to bonds. However, the Reserve Bank claimed that its purchases, which increased its investment portfolio in Banking Department to Rs. 13 crores by March 1940, had the steadying effect. [45]

Regarding defence loans the Government did not come to the market before June 1940. However, with the fall of France in the same month the gilt-edged market slumped again and consequently, the first Defence loan suffered a big blow. There was no other choice left to the authorities but to save the market by direct intervention. The Reserve Bank fixed the minimum prices of the government securities at the end of June with cooperation of the Bombay Stock Exchange authorities. This was the first action on the part of the monetary authorities to secure stability in the gilt-edged market. But they showed defeatism in fixing the minimum prices, as the prices fixed were low. [46]

In the meantime objective factors such as the plethora of money, the bursting of the boom, the reduced demand for money and the closing down of all investment opportunities on private account were favourable to a cheap money policy and pushed the short-term rates down. These developments combined with the desire to issue new defence loans, impressed upon the Reserve Bank the need to adopt open market operations as supporting measures. The second series of the Defence loans issued in August 1940 proved to be a success and the Bank followed a more energetic policy. In January 1941 the legal restriction on holding of rupee securities of more than Rs. 50 coores by the Bank in the Issue Department was removed. The Government started issuing ad hoc Treasury bills and no longer remained worried about its low cash balances. The Reserve Bank

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[45] Governors' Report, 1939, Governors' speech, P. r5.

[46] "Bombay Exchange authorities have been unduely timid and even defeatist in the choice of minimum prices. The minimum prices were unduely low." Indian Finance, July 6, 1940.

could operate more successfully on Treasury bills and the rate went down to Rs. 0.12.0 in March 1941 -the lowest rate ever recorded in the busy season-.

Thus, at the beginning of the war the debt management policy of the Reserve Bank was marked by a lack of determination resources and power. But after the initial setback with the Defence Loan of June 1940 the Bank achieved success with only small-scale intervention. It would be exagerating the role of the Reserve Bank if we do not take account of the objective factors favouring the policy of the Bank. However, even under the most favourable conditions, some amount of central banking action was necessary to bring about the desired result and the Reserve Bank should be given due credit for that. The Reserve Bank successfuly piloted the defence loan programme of the Government and it was able to get the loans subscribed at the lowest rates recorded.

In 1940-41 the Reserve Bank was able to sale Rs. 51 crores of rupee securities and another Rs. 61 crores of rupee counterparts. The Bank successfully withstood (without much panic in the gilt-edged market) the news of three military reverses, namely, Hitler's attack on Russia in June 1941 ; Japan's entry into the war In December 1941. and the Japanese thrust into the Eastern borders of India sometime in September 1942. On each occasion the Bank raised the minimum prices of securities, consequently each crisis proved to be of shorter duration than the previous one. The Bank was able to sell Rs. 56 crores of rupee securities and another Rs. 21 crores of rupee counterparts in 1941-42.

Once the conditions of low rates existed, i.e. the unusual phenomenon of currency expansion in the face of restricted channels of investment, the Reserve Bank could maintain it easily and the gilt-edged market continued to be firm. The Treasury bill rate was further brought down from the level reached in March 1941, and the amount continued to increase for the next two years. However, during the latter period of

the war the policy of the Government was to reduce the amount of Treasury bills. The Government was inflationary conscious during this period and the reduction of the large outstanding floating debt was considered as the right step. [47] At the same time, the Government intensified its borrowing programme. The amount of war loans sold by the Reserve Bank increased from Rs. 103 crores in 1942-43 to Rs. 315 crores in 1943-44.

In the later years, the gilt-edged market continued its firm tendency being mainly influenced by the favourable developments in the war situation, The continued abondance of short-term funds seeking investment in liquid form led to general improvements in prices. The Reserve Bank adopted a precautionary policy against indiscriminate use of bank-credit on Government or other securities purely for speculative purpose. The Bank advised the scheduled banks to refrain from extending credit against Government securities where the proceeds of such borrowings were to be used for purely temporary investment in Government securities with the aim of realising a speculative profit on a rise in prices. [48] The Reserve Bank further requested the banks to conduct their loans and investment policies in such a way as to help in the attainment and maintenance of the maximum degree of stability in the value of what had come to be the most liquid assets of the financial community in general and the banking system in particular. viz. Government securities. This advice had the desired effect of a general improvement in security prices. The index of security prices (1927-28 = 100) averaged higher at 118'0 in 1944-45 compared to 117'2 in the preceding year. [49]

During the war period medium-dated loans, varying from 9 to 12 years maturity dominated the borrowing policy of the Government. But as the war progressed and the market acquired

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[47] Budget Speech, Budget, 1944-45, P. 17.

[48] Vide Reserve Bank of India Circular, dated 22nd April 1944.

[49] Report on Currency and Finance, 1944-45 PP. 72-73

stability the average maturity of the loans was also extended further. Most of the defence loans were issued at 3 %, with only two exceptions in 1945-46, when the rate went down to 2¾ per cent. The sale of rupee counterparts was made at the same rate like other defence loans. One significant feature was that while the short rates like the Treasury bill rate went down further they failed to bring the long-rates down and consequently, the gap between the short and long rates widened. Monetary authorities were partly responsible because they did not try to push the rate below 3 per cent. As the money supply went on expanding in the fact of no alternative investment outlets the rate on defence loans could have been brought down to 2½ per cent if not to 2 per cent. Such an attempt sould have integrated the interest rate structure by bringing various rates in line with one another.

During the war-period the deposits of the banks increased considerably and the Reserve Bank wanted to draw them into the gilt-edged market. The Government also issued special short-dated bonds and large allotments of Treasury bills was made for the banks. As a result, the share of the Government security portfolio in the total assets increased from 39'8 % in 1939 to 58'8 % by the end of the war. Inspite of this healthy development, the banks went on building their cash and balances with the Reserve Bank, and the monetary authorities were unable to draw those into the market.

CHAPTER V

MONETARY PROBLEMS DURING THE POST-WAR AND POST-PARTITION YEARS

Immediately after the war there was an urgency to return from the artificial conditions of the war-economy to normal peace-time economy. The problems of transition from and reconstruction of the war-torn economy were further multiplied by the partition of the country. On August 15, 1947 India became independent and on than very day the country was divided into two political units, viz. India and Pakistan. The partition of the country not only caused dislocation of the economy and served immediately to increase inflationary pressure, but it also affected fundamental changes in the economic structure, which were to have long-term effects on the Indian economy. The attainment of political independence also meant a change in the attitude of the Government towards economic activity from that of laissez faire to active participation which found expression in successive development plans. Here we shall examine monetary and financial problems facing the country during the post-war and post-partition years extending from the end of the World War II to the end of the financial year 1950-51, after which India entered into a phase of planned economic development.

The post-war period, particularly the post-independence period constitutes, in the history of the Reserve Bank of India, as also in its monetary management, a period of transition to a new pattern which differs in many respects from those during and before the war. During this period the Reserve Bank emerged as a fully fledged central bank with wide experience, increased resources and a much wider field of operations to affect monetary and credit conditions of the country. The regular link which was established with the banking system during the war became stronger as the banks came to rely on the Reserve Bank to an in-

creasing extent for the supply of funds. This reliance will be evident from the loans and discount operations and purchase and sale of securities in the market by the Bank. There was also a change in the legal status of the Reserve Bank, i.e. the Bank was nationalised in September 1948 with effect from January 1949 and the enactment of the Banking Legislation in March 1949 bestowed on the Reserve Bank sweeping powers to control not only credit but the entire money market. The Banking Companies Act removed the long-felt inadequacy of ammunition and equipped the nationalised Reserve Bank with wide powers of qualitative credit control, besides powers to control the volume of credit. The Reserve Bank emerged from a position of non-entity and obscurity to that of an authority - asserting its influence as a regulator, controller, supervisor, inspector or rather a director of the money market.

DIFFICULTIES OF THE POST-WAR PERIOD AND THE PARTITION

The war left behind a legacy of problems : the first and foremost of which was the high inflationary potential in the economy. There was a huge expansion of currency and prices, index of which rose to 719.5 and 254.2 respectively by March 1946, unaccompanied by corresponding increases in the production of goods and services. The Government expenditure continued to be high showing big deficits for 1945-46 and 1946-47 [1] and the Allied expenditure also remained at a high level. [2] Balance of payments surpluses on private account combined with controls on prices and private spending had increased considerably purchasing power in the hands of the public. There were also large hoards of money accumulated during the war and ready to be released

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[1] The budget for 1945-46 was running a deficit of Rs.144 crores on revenue account with a surplus of capital account and for 1946-47 there was deficit on both revenue and capital accounts of Rs.45 crores and Rs. 62 crores respectively. Report on Currency and Finance. 1946-47, P.64-73.

[2] Recoverable war expenditure for 1945-46 and 1946-47 was Rs.374.54 crores and Rs.41.66 crores respectively. There were protests against the continued Allied Expenditure even after the war was over.

at the first available opportunity.

Against these forces of supressed-inflation and the back-log of demand, agricultural and industrial production continued to decline. [3] The immediate post-war period was also marked by a complete absence of private capital for new investment of for the replacement of old machines which were overworked to almost breaking point during the war. [4] Moreover, any large scale import of capital and consumers goods was ruled out as war-devasteted Europe could not have been expected to supply goods to India for sometime. The Provincial Governments, which built-up substantial reserves during the war, were eager to embark upon development plans drawn up during the war. Thus, while the pressure of demand from both private and public sectors was great, domestic availability of goods and services was hopelessly inadequate to meet the requirements of both the public and private sectors.

Inspite of the magnitude of inherited inflationary potential, in the immediate post-war period the Government feared a deflation in the near future to be brought about by a fall in Government expenditure. The Finance Member, Sir Archibald Rowlands, clearly visualised such a situation in his budget speech in February 1946 [5] and formulated economic policy accordingly.

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[3] The indices of agricultural and industrial production were :

	1947-48	1948-49	1949-50	1950-51
Agricultural Production	100.0	95.0	100.0	94.0
Industrial Production	97.2	108.4	105.8	105.0

Source : The Eastern Economist, Annual, 1953

[4] As for example, textile mills were frequently working 168 hours a week during the war. A.R. Prest, War Economics of Primary Producing Countries, P. 15. Also see Report on Currency and Fiannce, 1946.47, P. 13.

[5] Budget Speech, Budget February 1946. Such apprehension was not confined to India but also harboured by the industrialised countries of the West like the U.K. and the U.S.A.

The Government's economic policy was formulated with a view to reducing, on the one hand, the pressure of pent-up demand in the system and enabling, on the other, the Provincial Governments to proceed with "public expenditure of a useful kind" as provided in their respective plans. [6] In solving the problems of inflation and forestalling deflation great emphasis was placed on fiscal and direct control measures, while the authorities did not put much faith in monetary measures. This was not because of limitations of monetary measures in an underdeveloped country but such measures might bring about the other extreme of deflation. "If our object was merely to bring down prices it would be comparatively easy by applying the classical weapon of deflation of money supply. But such a deflation may gather cumulative force and get out of hand resulting in diminished output and employment." [7] Therefore, in principle, a dear money policy was ruled out and greater reliance was placed on fiscal measures such as tax concessions [8] to encourage private investment and output.

Not only was the fear of deflation unjustified in view of the inflationary pressure but measures taken by the Government were ill-conceived. Tax concessions combined with the gradual decontrol of a number of articles since the expiry of the Defence of India Rule in September 1946 encouraged speculative activities, particularly in commodities and intensified inflationary forces instead of helping investment and output. The general economic situation was further aggravated by the political uncertainties and communal riots. Then came independence and partition of the country which cut across the economic unity of the country built up over a century and reduced the supply of raw materials like jute, cotton and other agricultural commodities, especially, food products. Immediately after the partition

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[6] The Provincial Five-Year Plans amounted to an expenditure of Rs. 900 crores.However, the Government realised the impossibility of adding anything to productive capacity due to structural rigidities and other real difficulties. Budget, February,1946 p. 11.

[7] The Reserve Bank of India, Governor's Report, August 1948 P. 69.

[8] In the budget of 1946-47 direct taxes were reduced all round and particularly, the Excess Profit Tax was completely abolished.

followed the biggest migration in history of twenty million people in one year. This was also accompanied by huge military expenditure in Kashmir ; as a consequence, the proposed reduction in defence expenditure could not be effected. Thus, the short-term task of transition from the war-time to peace-time economy was not only delayed but ran into bigger difficulties in the two years after the war. There were urgent economic problems of an acute nature like the food shortage, the growing inflation and declining production. The problem of price stability and the initiation of a new monetary policy also required immediate attention.

THE NEW MONETARY POLICY : CONSOLIDATION OF THE CHEAP MONEY

The new monetary policy was announced by the Governor of the Reserve Bank of India in August 1947. For the first time since its establishment the Reserve Bank stated its views on the level of interest rates and the relative importance of monetary policy on the one hand ; and the fiscal policy and direct control measures by the Government on the other. The Governor of the Bank, Mr. C.D. Deshmukh, aimed at the "consolidation of the cheap money policy" rather than pursuing it any further. [9] He said that the Bank did not favour reduction in the rates reached at the end of the war. At the same time to deal with the growing problem of inflation the Bank did not think an upward revision of the interest rates was a suitable measure. "It does not appear appropriate to tackle the problem by a reversal of rates of interest as both in the immediate as well as in the long-run the consequences of such a reversal are bound to be adverse to the course of accelerated investment so directly needed for the country's development." [10] On the whole the Reserve Bank thought that monetary factors were less important than direct controls by the

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[9] The Reserve Bank of India, Governor's Report, August 1947, P. 47.

[10] Ibid, P. 43.

Government and fiscal measures in the context of the underdeveloped state of the Indian economy. It denied that the expansion of bank credit and open market purchases of securities by Bank that were made to maintain stability of the gilt-edged market contributed significantly to the increasing inflationary pressure.

The Economic Adviser's index number of wholesale prices rose continuously since the end of the war. It stood at 254.2 by the end of March 1946 and rose to 293,2 within a year ending in March 1947 inspite of controls on the essentials of life kike food, clothing and rents. Had there been no control, the prices would have rocketed because expenditure on these items constitute more than 70 % of total consumers' expenditure. [11] Inspite of rising price trends,food shortages on a large scale after partition and stagnation in agricultural and industrial production, the Government decided on gradual decontrol in November 1947 and the consequences were disastrous.

Inflation, which was supressed since the end of the war, was now apparent. The general index of wholesale prices stood at 302.0 in November 1947 when decontrol was decided upon and it advanced continually until it reached a new peak of 389,6 in July 1948 - an increase of 29 % within a few months. The rise was most marked in the case of decontrolled goods such as food and cloth, because of speculative hoarding and thereby great hardship was suffered by millions of people. One unmistakable lesson was that if strict controls were maintained on bare essentials, the price level could not get out of hand, although some increases were bound to occur form the high prices of other commodities.

Soon the consolidation of cheap money policy became a dubious concept. During the war-years the objective of a cheap money policy was clear, but with the gradual decontrol measures

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[11] R.C. Desai, Consumer Expenditure in India, P. 35-36.

since November 1947 there was doubt as to the ability of the monetary authorities to keep interest rates down. There could be no greater source of danger to a cheap money policy than the emergence of doubt as to the ability and willingness of the authorities to ensure its maintenance. The authorities failed to realise that there was an obvious connection between the maintenance of a cheap money policy and the elaborate system of controls [12] which, although not very efficient, was effective in many ways. Prices of decontrolled and other commodities increased sharply, causing a great inflationary demand for credit because of the diversion of funds to the commodity market. Consequently, a selling pressure developed which had the effect of damping down the security prices and thus making the maintenance of a cheap money policy difficult.

Another blow to the gilt-edged market and therefore to the cheap money policy came from the Reserve Bank itself. In a circular letter [13] it advised the scheduled banks to redistribute their portfolio of Government securities from long to short-term. Such advice was contrary to the so-called consolidation of the cheap money policy and anti-inflationary drive. This was a boon to the banks who rapidly unloaded long-term securities to increase their liquidity which helped to foster the forces of inflation and speculation. The Reserve Bank failed to understand that in establishing a pattern of interest rates and for the health of the gilt-edged market in a period of inflation, it was necessary that long-term securities should be more in favour with the genuine investors. [14] The strength of the market was further weakened by a decline in the volume of loans floated and a reduction in the tender of Treasury Bills as the Government had no clear objective of borrowings.

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[12] The Eastern Economist, January 1948.

[13] Circular No. DRS/905/SY-130-38 dated March 18, 1948

[14] Indian Finance, July 3, 1948,

The Reserve Bank was caught in a dilemma, not unlike that of the Federal Reserve System of the U.S.A. in the post-war period [15]; that is, either to reduce the liquidity in the system by open market sale of securities, which would have depressed the gilt-edged market and increased the rate of interest or to maintain the gilt-edged prices by purchasing more and more securities unloaded in the market and thereby enhance liquidity further. Between these two confliction objectives the Reserve Bank chose the latter alternative and decided to support the market. But the slow drift from the cheap money policy started from the beginning of 1948 and continued right up to the end of the period under review. Any drastic change was avoided by heavy purchases of securities by the Bank but various short-term rates moved up from their wartime levels, though the Bank rate remained stable at 3 %.

TABLE 11

SHORT-TERM MONEY RATES IN INDIA, 1945 - 46 to 1950 - 51

Year	Bank rate	Imperial Bank Hundi rates		Call Money Rates		Bazar Bill Rates		3-months Deposit Rates		6-months Deposit Rates	
		H	L	H	L	H	L	H	L	H	L
1945-46	3	3	3	½	½	7	6	1	½	1½	½
1946-47	3	3	3	½	½	10	6	1¼	½	1½	¾
1947-48	3	3	3	½	½	10	9	1¼	½	1½	¾
1948-49	3	3½	3	1¾	½	15	9	1½	1	1¾	1¾
1949-50	3	3½	3½	1¼	½	13	10	1¾	1	1¾	1½
1950-51	3	4	3½	1¼	½	13	10	2¼	1	2¼	1¼

Source : Annual Reports on Currency and Finance

After the physical controls were lifted in November 1947, the index of wholesale prices rose from 302.0 in that

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15 E.C. Simons, "Sales of Securities to Federal Reserve System under Repurchase Agreement" - Journal of Finance, March 1954.

month to 389.6 in July 1948 - at an average rate of 4 % per month. The shortage of consumers' goods - particularly foodstuffs, and of industrial raw materials ; the difficulties of replacement of old machines and transport bottlenecks all helped to sustain inflationary pressures. Alarmed by the possible adverse repercussions of this activation of latent inflation on the economy, the Government decided on a policy of gradual reversal of the decontrol measures. It reimposed price control and rationing of foodstuffs and cloth and made heavy purchases of food from abroad.

These steps were accompanied by a short-term Keynesian solution along the lines of a compensatory fiscal policy.[16] In the second-half of 1948 the Government announced its programme to counteract inflationary pressures which were at the back of the price increases. Measures proposed under this programme fell into two categories. Firstly, it aimed at keeping government expenditure down both at the Central and Provincial levels and reducing the excess purchasing power in the hands at the public. Such measures consisted of a balanced budget, deferment of excess profit tax repayments, limitations on dividend payments and an increase in the maximum amount that could be deposited in the post-office savings. Secondly, it aimed at increasing the volume of production of essential goods and services. Such measures consisted of high depreciation allowances, the abolition of capital gains tax, greater facilities for transport of goods, and selective tax-exemption of new plants and machines. [17]

Although the short-lived policy of decontrol did not help to stabilize the situation, as nobody except the Government, out of its inverted sense of logic expected that it

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[16] However, the efficacy of compensatory policy is doubtful in an underdeveloped country like India in the absence of sensitive built-in stabilizers.

[17] Report on Currency and Finance,1948-49 P. 67.

would ;[18] it wiped out most of the excess purchasing power in the hands of the community through price increases. After the adoption of the new measures the net effect of inflationary and deflationary forces was a decline of Rs. 43.3 crores in the money supply in 1948-49. The Economic Adviser's index of wholesale price declined to 370.2 in March 1949 from 389.6 in July 1958. However, the downward trends in the price level proved to be short-lived and started to rise again from April 1949. The index of wholesale price reached 389.8 in September 1949, thus exceeding the post-decontrol peak level reached in July 1948 and climbed to 393.3 in October 1949. A huge deficit in the balance of payments was the main counteracting influence. In 1948-49 (July to June) the net adverse balance of payment amounted to Rs. 227 crores, not counting payments to Pakistan and the United Kingdom on Government account. The deficit in the balance of payments was the biggest in India's history and culminated in the devaluation of rupee in September 1949. All the sterling area currencies, with the exception of Pakistani rupee, were devalued by 30½ %[19] in order to reduce imports from the dollar area and to increase exports to it.

The devaluation combined with the tightening of anti-inflationary measures by the Government had the effect of bringing the general index of prices down to 381.3 in December 1949. The balance of payment position, in place of a huge deficit showed a surplus of Rs. 19 crores in 1949-50. The Government of India's deposit with the Reserve Bank increased by Rs. 12 crores. Even then the supply of money continued to increase and after a brief lull the index of wholesale price started to rise from January 1950 and practically the whole im-

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[18] "As continuance of controls, apart from the administrative defects in their working, tended to perpetuate conditions of relative scarcity, causing in turn the prices of the controlled commodities to rise, the Government, in order to tackle this vicious circle, announced,... their policy of gradual decontrol." Report on Currency and Finance, 1947-48, p. 55.

[19] The Government of India devalued the rupee from Rs.3.30 to a dollar to Rs.4.76 to a dollar in September 1949. The rupee-sterling rate continued to be the same.

provement of the preceding two months was lost by March 1950. The price index moved up from 381.3 in December 1949 to 392.4 in March 1950 to 395.6 in June 1950 when the Korean War broke out.

All through this period, the Reserve Bank followed its professed policy of consolidation of cheap money. It assumed a type of negative attitude towards inflation and relied on the direct physical controls and anti-inflationary fiscal policy pursued by the Government. The only positive measure taken by the Reserve Bank was the screening of bank loans after the devaluation of the rupee to check speculative activities. It required all scheduled banks to submit to the Bank daily returns of all credit above Rs. 100,000 sanctioned by them. When it detected that advances were made for speculative purposes, it asked the bank concerned to recall such advances.[20] Apart from this measure the Bank acted on the premise that if its policy could not control inflation it should, at least, not contribute to it.[21]

There the Bank was mistaken ; its open market operations under the so-called consolidation of the cheap money policy became the source of inflationary finance. We have already noted the dilemma in which the Reserve Bank was caught in conducting its open market operations and the Bank's decision to stabilize the gilt-edged market in the face of inflationary pressure. Such a policy of pegged prices of securities left the

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20 The power to give such directions to banking companies in respect of advances was granted by the Banking Companies Act, 1949 ; See Section 27 (2)

21 "On a review of all factors, it would appear that monetary and credit policy has not contributed significantly to the inflationary pressure during the year, the post-devaluation trends in foreign trade being the main factor underlying the monetary expansion". The Reserve Bank of India, Governor's Report, August 1950, P. 19.

the initiative with the market and made it difficult for the Bank to keep the scheduled banks' use of its funds within limit. The banks unloaded their holdings of securities on a large scale to secure funds for more profitable employment. Most of the securities unloaded by the banks were taken up by the Reserve Bank under the arrangement that existed which made it nearly obligatory for the Reserve Bank to take up these securities from banks for providing seasonal demand for funds. But the banks declined to buy them back in the slack season. The Reserve Bank was continuously pouring money in to the system as its purchases were more than the net sale of securities. [22] The mechanical self-defeating open market operations of the Reserve Bank became more than apparent at the outbreak of the Korean war in June 1950. The sale of securities could not be maintained because banks released further their holdings of Government securities to provide finance for the war-induced buoyancy in the commodity markets.

At the outbreak of the Korean war the Western countries embarked on a programme of rearmament and of stockpilling of materials for a possible World War. Such a programme of stockpilling in the West especially in the United States produced a boom in India. Foreign demand for goods was running at a high level and there was a sudden spurt of speculative and hoarding activities within the country. While the pressure of demand from both within and outside of the country continued to be high consumers and capital goods could not be imported in sufficient quantities owing th the war-efforts in Europe and in the United States. The failure of the monsoon rains in the summer of 1950 caused a near famine situation in some States and

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[22] The Reserve Bank's open market operations were the main factor causing an increase in currency issue. nearly 33 % of the newly created money came from these operations and sustained inflation after the war-inherited liquidity in the system has exausted itself at the time of decontrol peak in July 1943. J.D. Sethi. op.cit. P. 189-203.

Referring to the post-war Federal Reserve System's policy Marriner Eccles said that the system "has become simply an engine of inflation". Quoted by R.F. Wallace "Some Reflections on Current War Finance" Journal of Finance. September 1951.

inflationary forces gathered momentum. In December 1950 the Government of India appealed to the Government of the United States for a loan of two million tons of wheat. The wheat loan was approved by the Congress in June 1951. In the meantime, credit inflation of a serious nature took place, particularly in the second half on the financial year 1950-51. [23] The money supply continued to increase owing to the balance of payments surplus and also because of the unloading of Government securities in large quantities by the banks in the busy season. The rising trend in the price level noticed since the devaluation was accelerated at the outbreak of the Korean war. Economic Adviser's index of wholesale prices which stood at 395.6 in June 1950 jumped by about 10 points to 405.2 in July 1950. The rate of rise was slowed down in the succeeding months but accelerated again in the busy months as the index increased from 414.3 in January 1951 to 438.6 in March 1951.

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[23] Seasonal expansion of bank credit amounted to Rs. 141.5 crores in four months between December 1950 to March 1951. Report on Currency and Finance, P. 57.

TABLE 12

INDICES OF SECURITY PRICES & COMMODITY PRICES

	Government Securities 1938 = 100	Variable Dividend Securities 1938 = 100	Index of whole-sale prices 1938 = 100
January 1947	104.6	237.8	283.5
July 1947	103.3	187.8	296.6
January 1948	103.2	177.6	333.4
July 1948	102.1	138.7	389.6
January 1949	101.7	128.9	376.2
July 1949	101.6	109.7	380.6
September 1949	101.2	117.0	389.8
January 1950	101.1	118.8	384.7
July 1950	100.7	118.8	405.2
January 1951	98.8	130.9	414.3
March 1951	98.6	132.8	438.6

Source : Banking and Monetary Statistics of India, Section 8, and Annual Reports on Currency and Finance.

The gilt-edged market which was falling continuously since the end of the war slumped at the outbreak of the Korean war : the index of security prices declined from 100.7 in July 1950 to 98.6 in March 1951. The sale of securities became extremely difficult in the face of mounting pressure for the unloading of the securities. [24] Another important feature to be noted in this connection was that so long as the attraction for commodities were strong both the equity and the gilt-edged prices declined. The Korean war brought about increased demand for Indian manufactures abroad and as the profit expectations rose the equity market, which was declining continuously since the end of the World War II. showed signs of improvement. The

[24] Total borrowings amounted to only Rs. 30 crores against the budget estimate of Rs. 70 crores. Reports on Currency and Finance, 1950-51, Section on Public Debt.

index of variable dividend securities which stood at 118.8 in July 1950 rose to 130.9 im January 1951 and to 132.8 in March 1951. As a result more and more funds were withdrawn from the gilt-edged market to be reinvested either in the commodity or in the share market as the war made both these markets equally attractive.

The period under review reveals an important feature of the Indian economy, that is in periods of rising prices there is a great demand for credit to be employed in commodities, and on the other hand, holders of money want to transfer from money to other assets. When the prices are rising at the rate of 2-3 % per month, nobody wants to lend at 3-4 % a year. The banks must offer higher rates to attract deposits, but other professional lenders can directly invest their funds in commodities or in real estate. Under such circumstances interest rates go up and an expansion of the supply of money cannot bring them down, as happened during this period, because more and more money is absorbed in higher prices. The experience of the post-independence years showed that it is the change in theprice level that affects the demand for money more than changes in interest rates and also that the changes in the supply of money affect the price level more than interest rates. The"Gibson's paradox" rules supreme indeed.[25]

There was a demand from some academic circles,[26] after the fashion of development abroad and because of the widening gap between the official rate and market rates, for an upward revision of interest rates. However, to raise the Bank rate by 1 or 2 % could not have made any material diffe-

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[25] J.D. Sethi, op. cit. P. 207.

[26] The demand for raising the official rate came from economists like V.K.R.V. Rao, cf. Presidential address to the Indian Economic Conference, December 1949 and from S.K. Muranjan, Shadow of Hyper Inflation, P. 35.

rence ot the situation and the authorities followed their old policy. After all, higher rates would have been inimical to the stability of the gilt-edged market and to some extent, however small, to investment activity.

OPERATIONS OF THE RESERVE BANK : 1945 - 1951

During the post-war and post-partition periods the banking system and money market passed through two distinct phases. The first phase extends from the end of the World War II in the middle of 1945 till the time of the decontrol peak in the middle of 1948 ; and the second phase extends from there onwards to the endof the financial year 1950-51.

The money market continued to rule easy for the first three years since the end of war. There was excess liquidity in the system inherited from war-finance. The call-money rates in Bombay among large banks continued to vary between ¼ to ½ % depending upon seasonal and political factors. However, these easy money conditions came to an end from the middle of 1948 onwards. There was a return to the pre-war pattern of alternating slack and busy season, which was submerged during the war under a flood tide of money supply. [27] All the short-term rates rose from their war-time levels and consequently the gulf between the market rates and the Bank rate widened. (See Table 16). This change in market conditions was also reflected in the assets and liabilities of the scheduled banks. In the first phase their total deposits and cash balances rose, but declined in later years as revealed by the following table.

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[27] Reserve Bank of India, Governor's Report, 1947, P. 20.

TABLE 13

DEPOSITS, CASH BALANCES AND ADVANCES OF SCHEDULED BANKS

1945-46 to 1950-51

(In crores of rupees)

Year	Total Demand & Time Liabilities	Cash hand & balances with Reserve Bank	Excess over mimimum requirements	Percentage of Cash Deposits	Total Advances	Percentage of Advances to Deposits
1945-46	914.05	124.71	51.99	13.64	301.12	32.94
1946-47	1048.65	122.36	38.51	11.67	427.71	40.79
1947-48	1050.54	140.73	58.60	13.40	444.36	42.30
1948-49	978.44	114.14	36.82	11.67	441.29	45.10
1949-50	870.38	100.32	30.51	11.53	442.09	50.79
1950-51	877.59	95.46	25.25	10.88	458.90	52.29

Source : Reports on Currency and Finance

LOANS AND DISCOUNT OPERATIONS OF THE RESERVE BANK

The easy money conditions of the first phase and market stringencies of the second phase is reflected in the volume of loans and discount operations of the Reserve Bank. The Bank Rate remained stable at 3 % throughout these years. The scheduled banks' dependence on the central bank for funds was slight for the first there years after the end of the war except in abnormal circumstances. However, from the middle of 1948 the banks relied heavily on the Reserve Bank for accommodation as will be evident from the following table.

TABLE 14

VOLUMES OF LOANS, ADVANCES AND DISCOUNTS AT THE RESERVE BANK, 1945-1951

(In crores of Rupees)

Quaterly Average of Friday Figures		Loans & Advances		Bills Purchased & Discounted	
		To Governments	To others	Internal Bills	Treasury Bills
1945	July	.46	.01	..	2.67
	October	.04	..	..	1.66
1946	January	.21	.95	..	7.18
	April	..	.09	..	5.15
	July	..	.06	..	.15
	October	.18	1.01	..	1.91
1947	January	.36	2.39	..	2.13
	April	6.63	.23	..	3.31
	July	.06	.23	..	3.73
	October	.06	.49	..	.87
1948	January	5.07	.01	..	2.72
	April	.41	..	..	7.19
	July	.10	.12	.15	2.04
	October	.95	4.41	.41	1.86
1949	January	5.90	11.25	.49	8.60
	April	2.40	6.05	.47	7.67
	July	11.06	8.16	.67	3.22
	October	.58	9.31	.08	1.77
1950	January	4.70	7.94	.53	4.83
	April	5.28	10.55	1.31	1.76
	July	1.92	8.74	1.09	1.36
	October	.45	3.49	..	1.07
1951	January	4.70	4.32	.50	4.06

Source : Banking and Monetary Statistics of India, 1954, P. 618-630

As in previous years, the Government continued to be the regular customer of the Reserve Bank. The amounts borrowed in the various quarters of the first three years after the end of the war did not show any substantial increase except in July 1947 and January 1948, when the amounts borrowed reached Rs. 6.63 and Rs. 5.07 crores respectively. In other quarters, the amount borrowed was less than one crore of rupees. However, from the middle of 1948 the volume of loans and advances to the Government showed a substantial rise. The main reason for the increased borrowings was the heavy deficits in the budget of the Government of India, In July 1949 the amount borrowed was Rs. 11.06 crores ; in other quarters the Government borrowings were also substantial as shown in the above table.

So far as loans and advances to the scheduled and cooperative banks were concerned, the amounts borrowed were not large during the first phase but they showed more regularly than in the previous years. It was only in October 1946 and January 1947 that the amounts borrowed exceeded Rs. 1 crores. The reason for the sudden jump in the central banking accommodation was the banking crisis in Bengal towards the end of 1946 and also the political uncertainties which led to communal riots.

Towards the end of 1946 there was general unrest in Bengal, including Hindu-Moslem riots. This unrest caused a panic and was followed by heavy withdrawals of deposits from some banks, especially from the smaller non-scheduled banks. Under normal cicurmstances the affected banks would have approached the Imperial Bank for assistance ; but the employees of the Imperial Bank in that area had gone on strike at that time. Consequently, the banks had no other choice but to approach the Reserve Bank for help. The Reserve Bank acted promptly and efficiently in the crisis. The Bank charged a concession rate of 2 % for loans and advances to the affected banks, even though the Bank rate was 3 %. It charged 1½ % from the cooperative banks for loans. To increase further availability of central bank credit, it abolished the seven-day minimum interest clause

from its loans and advances in May 1947 and agreed to charge only for the days the loans were outstanding.

From the middle of 1948 onwards the volume of loans and advances to the scheduled and cooperative banks showed a substantial increase compared with the previous years, owing to the stringency in the money market. It reached an all time record of Rs. 11.25 crores in January 1949 ; in other quarters the volume of loans and advances remained at a high level. Another noteworthy feature during these years was the emergency advances against papers deemed adequate by Reserve Bank. Emergency advances amounted to Rs. 0.76 crores in 1948, Rs. 0.85 crores in 1949 and Rs. 0.24 crores in 1950. [28] The emergency advances showed slow realization on the part of the Reserve Bank, of its role as a central bank in an underdeveloped country like India with a disorganised system. It also demonstrated the growth of confidence in the leadership of the Reserve Bank on the part of banks. This becomes all the more evident when one compares this crisis with the banking crisis in June 1938.[29]

Before July 1948 there was no rediscounting of commercial bills by the Reserve Bank. The volume of internal bills purchased and discounted by the Reserve Bank started from a modest figure of Rs. 0.15 crores in July 1948 and reached Rs. 1.31 crores in April 1950. The amount was not large but the discounting was steady. The internal bills were exclusively agricultural bills discounted by the cooperative banks.

The purchase and discounting of Treasury bills from the scheduled banks became a regular feature of the Reserve Bank's operations and the amount of such bills purchased or dis-

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[28] Trends and Progress of Banking in India, 1950, p. 28-29. The Emergency advances were made under Section 18 of the Reserve Bank of India Act, 1934. Terms of advances were not published.

[29] Cf. Supra. Chapter IV, P. 100

counted increased from year to year. The amount of outstanding bills showed a seasonal pattern, being greater in the first two quarters of the year. The seasonal pattern meant that the banks preferred to supplement their reserves during the busy season by selling Treasury bills to the Reserve Bank. rather than by borrowing from it in the form of loans and advances.

OPEN MARKET OPERATIONS OF THE RESERVE BANK -
The Dilemma of the Cheap Money Policy

The success with which the Reserve Bank conducted its open market operations during the war period in order to maintain a cheap money policy depended partly on the plethoric money supply in the face of limited investment opportunities and partly on the initiative of the Reserve Bank, But in the post-war and post-partition periods open market policy of the Bank ran into serious difficulties for several reasons. The base of open market operations remained narrow because of the absence of certain institutional arrangements like a bill market, a well developed money and capital market and a well-organised and regulated market in Government securities. No attempt was made to remove some of these obstacles even after the independence in August 1947, and once the excess liquidity in the system had evaporated the maintenance of cheap money through open market operations became extremely difficult in somewhat normal circumstances in the post-war years. Even regular guidance from the monetary authorities, which was developed during the war-period, had degenerated into passivity and consequently, the market became doubtful regarding the intentions of the authorities.

We have already noted the dilemma of the Reserve Bank in conducting open market operations, that is, either to sell securities to check inflationary pressure or to purchase them if offered for sale in order to stabilize the gilt-edged market. The Bank decided to support the gilt-edged "on a substantial scale, to help maintain security prices and

to stabilize the banking and financial structure." [30] Nearly two-thirds of the Government securities were held by institutional investors, of which the banks were the largest holders. Most of the securities unloaded by the banks were taken up by the Reserve Bank under the arrangements that existed then for providing seasonal finance. It was nearly obligatory for the Reserve Bank to take up these securities from banks. But a very significant feature was that the banks were selling securities on a large scale even in the slack season in order to secure funds for more profitable employment. The Reserve Bank conducted open market operations so regularly and mechanically that the banks came to regard their holding of securities as liquid as cash with the result that the more the Reserve Bank sold securities in the market the more the banks unloaded their securities. All through these years, the Reserve Bank was pouring inflationary finance as its purchases were more than its net sale of securities, although it was the exact opposite of what the Reserve Bank wanted to achieve by open market operations. The position is revealed in the following tables.

TABLE 15

OPERATION IN CENTRAL GOVERNMENT SECURITIES WITH THE PUBLIC ON THE RESERVE BANKS INVESTMENT ACCOUNT

(In crores of Rupees)

Financial Year	Purchases	Sales	Net purchase Sale
1945 - 46	45.77	70.30	24.53
1946 - 47	95.35	33.06	- 62.29
1947 - 48	75.76	23.42	- 52.34
1948 - 49	121.84	30.42	- 91.42
1949 - 50	89.22	70.68	- 18.54
1950 - 51	155.06	98.79	- 56.27

Source : Reserve Bank of India Bulletin, June 1960.

[30] The Reserve Bank of India, Governor's Report, August 1947, P. 18

TABLE 16

RATIO OF INVESTMENT TO LIABILITIES OF SCHEDULED BANKS

(In crores of Rupees)

End of	No. of Reporting Banks	Investment in Government Securities	Total Demand and Time Liabilities	Percentage of Investment in Securities to Total Liabilities
December 1945	89	496*	933	53
December 1946	90	494*	1051	47
December 1947	93	484*	1063	46
December 1948	94	450	963	47
June 1949	91	344	875	39
December 1949	92	357	854	42
June 1950	92	354	863	41
December 1950	89	366	877	42
June 1951	87	300	883	34

* Comprises investment in Central and Provincial Government Securities only, and related to undivided India.

Source : Reserve Bank of India Bulletin, September 1951.

There were two distinct movements in 1946-47 in the security market. There was a boom in the first four months especially in July and August. In July 1946 the Government announced the flotation of the biggest single loan ever issued i.e. the 3 % Conversion Loan of 1986. The issue was at par and the total amount subscribed came to Rs. 247 crores. This operation was the culmination of the cheap money technique developed during the war. It gave strength to the market as the yield of 3 % Bonds fell in the course of one month from 2.71 % to 2.57 %. The Reserve Bank tried to stem the sharpness of the fall by selling securities from its investment account. However, from the middle of August there was a serious setback due to political uncertainties and communal disturbances. These disturbances created a state of nervousness among depositors and the banks had to unload

securities to meet the heavy withdrawal of deposits. There was an increased trade demand for funds owing to growing inflation and the banks further unloaded securities in the busy season of 1946-47. The gilt-edged market suffered badly and the security prices began to decline. In 1946-47 the Reserve Bank purchased in the open market securities worth Rs. 95 crores and sold only Rs. 33 crores the net purchases thus aggregating Rs. 62 crores. The pressure of unloading securities remained undiminished in 1947-48 as purchases amounted to Rs. 75 crores and sales Rs. 23 crores. showing net purchases of Rs. 52 crores.

The year 1948-49 was a tiring year for the Bank authorities. There were heavy withdrawals of funds from the bank following decontrol measures, and consequent price increases. So much so that the deposits of the scheduled banks declined by Rs. 95 crores. Heavy withdrawals of funds compelled the banks to liquidate their investment in Government securities. The Reserve Bank continued to support the gilt-edged market in order to maintain prices of securities stable and stabilize the interest rates. There was a shift on the part of the banks from Government securities, which had been acquired on a large scale furing the war, to more renunerative employment of their funds in the form of loans and advances to trade and industry. In the post-war period there was also a tendency to enlarge imports which had been drastically reduced in the war years, and the banks unloaded securities to purchase foreign exchange from the Reserve Bank. The Reserve Bank's directive to Banks to redistribute their security portfolios from long to short-term added its share to the mounting pressure of unloading securities by the banks. In 1948-49 the Reserve Bank purchased Rs. 122 crores of securities and sold Rs. 30 crores, the net purchase amounting to Rs. 92 crores - the largest net purchases in any year in the history of the Reserve Bank. Such activity had its inevitable effect , the market remained depressed and security prices began to fall. However, any drastic change was avoided by heavy and continuous purchases by the Reserve Bank at or near par. But most short-term rates, with the exception of the Bank rate rose from their pre war-time levels.

With the outbreak of the Korean war in June 1950, and its consequent development in the internal and international spheres, together with an increase in speculative activity, there was a sharp increase in the demand for funds during the busy season which extended to about the middle of May 1951. To meet this demand for funds, commercial banks were compelled to liquidate their holdings of Government securities. Consequently, the gilt-edged prices sagged and the rates of interest moved up rapidly. By December 1950, the gilt-edged market had reached a very low level. with the 3 % Conversion Loan, for instance, quoting at Rs. 93. To prevent a further deterioration in the security market and to put more funds in the market to meet seasonal demand, the Reserve Bank which amounted to Rs. 18 crores in 1949-50 increased sharply to Rs. 56 crores in 1950-51.

Open market operations of the Reserve Bank during the post-war years stand in sharp contrast to the achievement of the war-period. In the last four years of the war, the net borrowing amounted 720 crores whereas in the four years from 1947-48 to 1950-51, the total market borrowing, excluding Treasury Bills and Treasury Deposit Receipt, were of the order of Rs. 166.6 crores while total outgoing in the form of repayments of maturing loans were Rs. 265.4 crores. Thus, there was a net reduction of nearly one hundred crores of rupees, although the objective was to raise more funds from borrowing.

The rates of interest on loans went on falling during the war period but rose in the post-war period. However, it would be wrong to assume that the open market operations of the Reserve Bank had no effect in the post-war years. The Bank was able, through its purchases, to avoid any drastic change in the security prices and in the rates of interest and to produce a steadying influence on the money market and the banking system.

CHAPTER VI

MONETARY POLICY DURING THE FIRST FIVE-YEAR PLAN

During the first three years of independence there existed, as we have seen in the previous Chapter, total confusion regarding economic objectives as well as the method and policies to be employed to achieve those objectives. The country was still recovering from the dislocation caused by the war and partition. There were acute shortages of food and raw materials ; industrial production was far below the installed capacity and the transport system was one big bottleneck. Inflation in India continued uninterrupted since the beginning of the Second World War and was given further stimulus by successive events such as the partition of the country in August 1947, the devaluation of the rupee in September 1949 and by the Korean War from June 1950 onwards. The situation was further aggravated towards the end by the unusually bad crop in 1950-51 and imports of food had reached the figure of 4.7 million tons. The population was growing at the rate of 1.3 % per year and the rehabilitation of a large number of refugees, about 20 millions, from Pakistan, presented a special problem. The standard of living of the people went down further from the already miserably low level of the pre-war days. Such a state of affairs could not last long in the face of poverty and economic stagnation ; and independence did not mean much to the teeming millions without any noticeable improvement in their standard of living.

It was to this end that the Government of India set-up a Planning Commission in March 1950 and asked it to make an assessment of the resources of the country and to formulate a plan for the most effective utilization of the country's resources. In July 1951 the Planning Commission presented a draft outline of a development plan for a period of five years from April 1951 to March 1956. After a "nation-wide discussion" there emer-

ged the final plan known as the First Five Year Plan, in December 1952. Here, we shall point out, in brief, the main features of the First Five Year Plan - its objectives and achievements before analysing the monetary policy and operations of the Reserve Bank during the first phase of planned economic development in India.

1. THE FIRST FIVE YEAR PLAN, Objectives and Achievements :

The central objective of planning in India was "to initiate a process of development" so that the "living standard of the people may be raised" and "new opportunities may be opened up to the people for richer and more varied life". [1] The First Five Year Plan aimed at utilizing more effectively the available human and material resources so as to obtain larger output of goods and services, while at the same time reducing inequalities of income and wealth. The goal was to raise substantially the economic and social standards of the people with a view to doubling the per capita incomes by about 1977. [2] The First Plan was intended to prepare the ground for a more rapid and balanced development of the economy in the future.

The Planning Commission, in its effort to present a coordinated view of the requirements of the economy and to reconcile various conflicting objectives, were guided by two dominent ideas. The first of these was that the Plan and its scope had to be modest in view of the difficult economic situation. It was provided that the national income was to rise from Rs. 9,000 crores in 1950-51 to Rs. 10,000 crores in 1955-56. i.e an increase of about 11 % over five years. This was to be

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[1] Government of India, Planning Commission, The First Five Year Plan, 1952, P. 1.

[2] Ibid, P. 23.

achieved by stepping up annual investment from 5 % in the beginning of the Plan to 6¾ % in 1955-56 - a very modest increase, indeed, in view of themagnitude of the problems. This proposed increase in investment was to be achieved by plouging back 20 % of the additional income during the Plan period. [3]

Secondly, the State would have to play a crucial role as the bulk of the development expenditure was to be incurred in the public sector because, the Commission thought, the private sector could neither work according to a list of national and social priorities nor undertake investment of the magnitude necessary for initiating a development process in the country. While this did not involve complete nationalization of the means of production, business and industry it meant a progressive widening of the public sector and a reorientation of the private sector to the needs of a planned economy. The total development outlay provided in the Plan amounted to Rs. 2069 crores for the public sector, the private sector's programme was limited to Rs. 1500-1600 crores. [4] The following table shows the allocation of resources under the main headings of development as provided in the First Five Year Plan for the public sector.

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[3] Ibid, P. 23.

[4] Ibid, P. 21.

TABLE 17

ALLOCATION OF RESOURCES IN THE FIRST PLAN FOR THE PUBLIC SECTOR

	Outlay during 1951-52 to 1955-56 (In crores of Rs.)	Percentage of total outlay
L. Agriculture & Community Development	361	17.5
2. Irrigation	178	8.1
3. Multipurpose irrigation & power projects	266	12.9
4. Power	127	6.1
5. Transport and communications	497	24.0
6. Industry	173	8.4
7. Social Services	340	16.4
8. Rehabilitation	85	4.1
9. Miscellaneous	52	2.5
Total	2,069	100.0

Source : The First Five Year Plan, p. 70.

The table reveals the pattern of priorities as envisaged in the Plan. In determining the pattern of priorities the Planning Commission took into account the immediate need of the economy as also the desirability of initiating certain long-term changes in the economic structure. Agricultural development received the highest precedence in view of the difficult food situation and the raw materials shortage.

Next to agriculture, came generation of power which combined with improved transport and communications, was intended to create the ground for future industrial development. The Commission viewed the problem of development over a 25 years period and did not limit itself to 5 years only ; hence indus-

trial development was left over for the successive five year plans. A sum of Rs. 533 crores, i.e. more than 20 %, was allotted to social services,such as education, health, housing and rehabilitation with a view to strengthening the infra-structure. In the sphere of industry, the amount sanctioned was 8.4 % of the total outlay. The progress in the industrial sector, however, depended on the efforts in the private sector for the time being as the bulk of resources available to the public sector was taken up for the improvement in agriculture, irrigation, power and the transport system and the social services.

The total development outlay of Rs. 2069 crores in the original plan was later raised to Rs. 2356 crores. But an ex-post analysis revealed that the actual expenditure fell short and amounted to Rs. 2060 crores without much distortion in the above mentioned pattern of priorities. The following table indicates the mobilization of resources for financing the First Five Year Plan.

TABLE 18

MOBILIZATION OF RESOURCES FOR THE PLAN IN THE PUBLIC SECTOR

(Ex Post)

S o u r c e s	Amount in crores of rupees	Percentage of the Total
1. Taxation and surplus of Railways	752	38
2. Market borrowings	205	10
3. Small Saving and unfunded debt	304	16
4. Other Capital receipts	91	5
5. External Assistance	188	10
6. Deficit financing	420	21
Total	1,960	100

Source : Review of the First Five Year Plan, P. 35.

All these sources of finance are self-explanatory with the exception of the last one which needs some clarification. The term "deficit financing" in the context of Indian planning refers to the excess of Government expenditure over its receipts from two sources, viz. taxation and borrowings. This overall deficits in the Centre and State Governments' revenue and capital accounts have been defined by the Planning Commission as "deficit financing" ; and it is in this sense that the term will be used in subsequent pages unless stated otherwise. This over-all and combined budgetary deficit amounted to Rs. 420 crores in five Years. It is important to make a distinction between this concept and the method of financing such a deficit. For example, the whole of this deficit was not met by an expansion of currency : only one-half of it was met by currency expansion and the other half from other sources, such as drafts on Sterling reserves.

Over the five years of the Plan national income of India increased by about 17.5 %. [5] In order words, the rate of growth of the economy was approximately one and a half times the planned rate. The output of food grains was expected to increase by 7½ million tons, whereas the actual increase was about 11 million tons ; similar was the case with other agricultural products. The net output in the agricultural and ancilliary fields showed an increase of 14.7 % ; this increase was primarily due to the fortuitous circumstances of good monsoon. The combined sector of mining, manufactures and small

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[5] Government of India. Planning Commission, Review of the First Five Year Plan, May 1957, P. 8.

enterprises showed an increase of 18.2 %. [6] Production increased at a rate faster than the increase in invested capital ; this was, to some extent, due to the existence of unutilized capacity in many industries at the commencement of the plan. The increase in commerce, transport and communications was 18.6 % and that in other services 23.7 %. The advance in large-acale industries was more rapid than in any quinquennium earlier. [7]

While the rate of progress and increase in national income was considered to be satisfactory its pace was unsteady and fluctuating. There was a large increase in 1953-54 and 1954-55 as a result mainly of the increase in agricultural output. As much as 13 % of the increase in national income was thus registered by the end of the third year of the Plan ; in the two subsequent years, the rate of increase diminished and in fact in 1955-56 the increase was nominal. The Planning Commission estimated that per capita income increased by 10.5 % and that levels of consumption increased by about 8 % over the plan period. [3]

It is necessary to make a distinction between development expenditure and investment as these two are different concepts. The former refers to the expenditure on projects and schemes outlined in the Plan, a part of which was not investment, and the latter relates to total investment, both inside and outside the Plan, in the expost sense of difference

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[6] Indices of agricultural and industrial productions were :

Agricultural production (Base year 1949-50 = 100)

1950-51	1951-52	1952-53	1953-54	1954-55	1955-56
95.6	97.5	102.0	114.3	117.0	116.8

Industrial production (Base year 1951 = 100)

1951	1952	1953	1954	1955	1956
100.0	103.0	105.6	112.9	122.2	132.6

Source : The Reserve Bank of India Bulletin, November 1959.

[7] Review of the First Five Year Plan, P. 8.

[8] Ibid P. 8.

between national income and consumption. Estimates of broad totals of investment prepared by the Planning Commission revealed that during the First Five Year Plan investment in the public sector aggregated to Rs. 1500 crores, while that in the private sector was close to Rs. 1600 crores - a total of Rs. 3100 crores against the original target of Rs. 3500-3600 crores. [9]

The level of development expenditure was low in the first two years of the Plan and it was stepped-up as from the third year, the step-up being particularly large in the last two years, which accounted for almost two-thirds of the actual outlay over the five year period. This pattern of growth of public development expenditure was reflected in the pattern of investment. More than 50 % of the investment in the public sector materialised in the last two years. Private investment also rose substantially in these years. [10] The level of investment in the economy by the end of the Plan period was about double the level in 1950-51. Saving-income ratio rose from 5.9 % during 1950-53 to 7.3 % during 1953-56, the average being 6.7 % during the Plan period. The marginal saving incomes ratio, i.e. the increment of saving as a proportion of the increment in income was as high as 19.1 % during 1953-56. Capital-output ratio, i.e. the ratio of investment to increase in income, during the first Five Year Plan was estimated to be 1.8 : 1 against the original estimate of 3 : 1. [11] This was primarily due to the windfall circumstances of good weather and greater utilization of unutilized capacity in many industries.

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[9] Ibid, P. 9

[10] "There were thus two distinct phases in the Plan. The first phase in which, apart from the accumulation of inventories in 1951-52 the level of investment, public as well as private, was relatively low, and the second phase in which it rose markedly." Ibid, P. 9.

[11] The Reserve Bank of India Bulletin, "Estimates of Saving and Investment in the Indian Economy, 1950-51 to 1958-59", August 1961, P. 1211.

THE NEW MONETARY POLICY

The prevailing inflation which loomed large over the deliberations of the Planning Commission not only formed the background to but also determined the course and direction of monetary policy to be pursued in the following years. Inflation in India, continued unabated even after the end of the war and before it could flatten out, it was given a fresh stimulus by the partition of the country devaluation of the rupee and later by the Korean war boom. It was also realised that in the early stages a development plan necessarily increases money incomes faster than and far ahead of increases inproduction and this carries with it the danger of inflation and instability. The deficit financing required by the Plan also created apprehension that it would add force to the cumulative process of inflation. The Plan was prepared in the context of inflation, and the Commission realised that unles there was a check to the inflationary pressures, it would be difficult to fulfill the targets of the Plan. It emphasised the necessity of financial and physical controls and recommended that the Reserve Bank should acquire a greater degree of control over the bank credit in the country.

This general policy recommendation of the Planning Commission was left to the Finance Minister Mr. C.D. Deshmukh to formulate in details and put into practice. The Finance Minister had already made clear several times his dislike of a cheap money policy during his Governorship of the Reserve Bank and his sympathy for a dear money policy in a limited range. He found his views being endorsed by the changing attitude to monetary policy in developed countries, particularly in Great Britain. [12] He aimed to tacle the problem of price inflation

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[12] In almost all countries in Westerm Europe, with the exception of Belgium, the respective Bank rate was raised in 1951. The Bank of England raised its Rate on November 8, 1951.

from the side of the supply of money through the combined force of budgetary surpluses and sale of securities or what he called "to adjust the money supply to the availability of goods."[13] He changed the five-year old open market policy from one of purchase to sale of Government securities ; he allowed upward adjustment of interest rates ; manipulated the fiscal system for budgetary surpluses and deliberately allowed deficits in foreign trade. [14] Recourse to these measures were made even before the beginning of the Plan.

Broadly speaking, the principle of contractionist monetary policy in a period of expanding fiscal policy was a sound one. But the danger lay in the Reserve Bank's reading either too much or too litle into the fiscal operations of the Government and their repercussions. The first question that needed to be asked was how much monetary expansion was planned in the wake of deficits between the resources required by the Plan and the planned expenditure. In the Plan there was a gap of Rs. 655 crores which was to be met from further external assistance or in the absence of it, by additional measures of internal taxation and borrowings and from decicit financing, which was estimated to be Rs. 290 crores. [15] However, the major part of this deficit was to be incurred in the last two years of the Plan, i.e. 1954-55 and 1955-56, because big projects involving huge outlays could be started only when equipment was available from abroad and proper surveys had been made at home. Therefore, any monetary expansion from the above mentioned deficits had not become significant in the first two or three years of the Plan. This particular phasing of the fiscal policy required a corresponding phasing in the monetary policy. There was no logic to adopt, as the Reserve Bank did, a contractionist monetary policy in 1951-52, i.e. three years in advance, to match an expanding fiscal policy of monetary expansion in 1954-56.

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[13] The Eastern Economist, March 3, 1951.

[14] The Finance Minister argued "if our deficit was equal to our balance of payments deficits, it will be neutral so far as inflationary situation was concerned." Parliamentary Debates, 4 June 1951.

[15] The First Five Year Plan, A Summary, P. 15.

The new monetary policy was not announced until November 1951, but in the meantime budgetary surpluses, sale of securities and foreign trade deficits were producing the desired effect on the money supply. The first action of Mr. C. D. Deshmukh's dear money policy was directed towards raising the interest rates. The Bank rate was raised from 3 % to 3½ % on November 11, 1951 ; and this put all other rates on a new higher level at which they remained until the last year of the First Plan.

TABLE 19

SHORT-TERM MONEY RATES, 1949-50 to 1955-56

(In % per annum)

YEAR	Bank-Rate	Treasury Bill Rate	Imperial Bank Hundi Rate		Call Money Rate				Bazaar Bill rate				3-months deposit rate			
					Bombay		Calcutta		Bombay		Calcutta		Bombay		Calcutta	
			H	L	H	L	H	L	H	L	H	L	H	L	H	L
1949 - 50	3	--	3½	3	1¼	½		½	8¼	1½	12	10	1	--	1¾	
1950 - 51	3	--	4	3½	1½	½	1¼	½	9	8¼	12	10	2¼	1	¾	½
1951 - 52*	3	--	4½	4	3	½	2½	½	9	8½	12	10	3¼	1¾	2¼	½
1952 - 53	3½	2'22	4½	4	3	½	3	1½	9¾	9	12	10	3¼	1¾	2¼	2
1953 - 54	3½	2'45	4½	4	3	¾	2¾	1¼	9¾	8½	12	10	3	2	2¼	2
1954 - 55	3½	2'53	4½	4	3	¾	3¼	1¼	9¾	9	12	10	3¼	2¼	2¼	2
1955 - 56	3½	2'52	5	4½	3¾	1¼	4¼	2¼	10¼	9¾	12	10	3½	2½	2½	2

* In November 1951, the Bank Rate was raised to 3½ %.

Note : H for highest and L for lowest

Source : Reports on Currency and Finance, 1955-56.

The official explanation was that bank credit created in the busy season of 1950-51 dit not return in the slack season of 1951 and the proportion of bank advances to deposits remained unusually high. Further, despite high level of advances, it was stressed, the share of industry and commerce in total did not show any great change. These were, according to the Reserve Bank "unusual and unconventional" developments.[16] However if we examine events closely we find that there was little ground or reason to justify such a step as raising the Bank rate. It was not the whole of the bank credit created in the busy season of 1950 - 51 which did not return in the following slack season; nearly Rs. 53 crores of advances were returned to the Reserve Bank between July and September 1951. [17] However, a substantial portion of money created in that busy season was retained in the economy. But the rationale of this behavior lay in the contraction of the money supply when national income started to rise after years of stagnation. The need for more money and the rise in national income, at least in the same proportion, if not more, is axiomatic. Under such conditions, credit created in one busy season may not return in the following slack season if currency does not increase. All that happened was that bank credit was more intensively used in the face of a declining money supply.

The money market was unprepared even for ½ % rise of the Bank rate because the underlying economic situation did not warrant such an action. The speculative aspect of the high demand for credit could not be ruled out, but ½ % rise in the Bank rate was a poor solution to the problem of that kind and it hit genuine investors more. Furthermore the general price level started falling ; the index of whole sale prices fell from 458.0 in April to 435.0 in November - a fall of 6 % in six months showing that under the impact of the new contractionist monetary policy and changing international demand for goods the inflationary pressure was subsiding. A rise in the Bank rate was not needed

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16 Report on Currency and Finance, P. 58.

17 Ibid, P. 152-3.

at that time. Finally, it came at a time when the gilt-edged market was sagging for months and it aggravated the situation further.

Second, to make the Bank rate effective a fundamental change was needed for the central bank credit in the place of existing arrangements. It was a normal practice of the Reserve Bank to buy Government securities offered to it for sale at market rates ; such a practice robbed open market operations of their real significance as the market was in a position to augment the money supply freely even in the midst of inflationary pressure. Simultaneoulsy with the raising of the Bank rate, the Reserve Bank announced that during the ensuing busy season, it would, except in special circumstances, refrain from buying Government securities to meet the seasonal requirements of scheduled banks, but would, as a normal practice, advance money at the prevailing Bank rate on Government and other securities. Though the banks were availing themselves of the facility of pledging Government securities for busy season advances, the amounts so obtained generally tended to be small, there being an obvious preference for accomodation through the sale of securities. This change of procedure was intended to make of Bank rate effective, at the same time it ensured that at the end of the busy season the securities would be returned and the money supply contracted automatically. [18] This emphasis on the mechanical expansion and contraction of the money supply by the Reserve Bank in a period of rising national income denied money of its role in an expanding economy as envisaged by the Planning Commission. The following table reveals seasonal variation in money supply and banking situation over the first plan period.

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[18] The Reserve Bank of India, Governor's Report, August 1952, P. 14.

TABLE 20

SEASONAL VARIATIONS IN MONEY SUPPLY AND BANKING SITUATION

(In crores of rupees)

	1951 - 52		1952 - 53		1953 - 54		1954 - 55		1955 - 56	
	S	B	S	B	S	B	S	B	S	B
Currency with the public	- 109'7	+ 53'2	- 104'3	+ 103'1	- 124'6	+ 115'0	- 96'8	+ 190'0	- 32'1	+ 237'2
Demand deposits of banks (net of inter-bank deposits)	- 9'3	+ 28'8	- 13'0	- 18'2	- 2'6	+ 10'7	+ 26'0	+ 31'8	+ 28'0	+ 26'5
Other deposits with the Reserve Bank	- 11'4	--	- 9'4	- 0'2	- 0'4	+ 5'8	- 6'6	+ 0'3	+ 0'9	+ 0'1
Cash on hand and balances with the Reserve Bank of banks	+ 24'8	- 32'6	+ 18'4	- 26'5	- 10'1	- 8'7	+ 20'4	- 11'9	+ 12'1	- 7'9
Advances and bills purchased by banks in India	- 82'6	+ 92'7	- 120'3	+ 180'3	- 79'8	+ 107'8	- 63'8	+ 102'6	- 30'1	+ 183'0

Note : S for slack season and B for busy season.

Source : Reports on Currency and Finance, 1955 - 56.

The third policy pronouncement related to the Reserve Bank's withdrawal of support from the gilt edged market. With the raising of the Bank rate and the inevitable steep fall in the prices of Government securities, the support had to be withdrawn. It created a near panic situation in the market and the Reserve Bank had to issue a press communique on November 20. 1951, stating that it was responsible for the maintenance of the financial credit of the Government and if circumstances justified such a course, it would take appropriate measures to maintain Government credit. [19]

The last measure, namely, the introduction of the bill market scheme in January 1952 was of outstanding significance and, it was feared that without it the new monetary policy would have precipitated a banking crisis. It was officially recognised that "owing to lower deposits, higher prices, large imports and reduced Government securities holdings resulting from net sales to the Reserve Bank for financing seasonal requirements, the capacity of scheduled banks to meet trade demand has been unduly strained. It was therefore imperative that a determined attempt should be made to overcome the difficulties by the developemnt of usance bills." [20] The bill market scheme provided that advances would be granted to the scheduled banks by way of demand loans on the security of usance promissory notes of their constituents.

The bill market scheme was probably the single important step since the inception of the Reserve Bank towards the development of a proper money market in India. But the scheme was introduced rather too late for that particular busy season; it came into effect towards the end instead of at the beginning of the busy season when other restrictive measures were introduced. The measures which were intended to restrict credit such

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19 Ibid, P. 17, Trends and Progress of Banking in India, 1951, P. 4.

20 The Reserve Bank of India, Governor's Report, August 1952, P. 17.

as raising the Bank rate and refusal to buy securities came into force in November, whereas the measure to liberalise credit, like the bill market scheme came much later. The result was confusion and panic in the market leading to a greater demand for liquidity thus causing very difficult money conditions when the money supply was contracting. A newly created bill market could not, on its own, fulfill the necessary functions immediately. However, inspite of the lateness of the scheme and the usual teething troubles, the bill market scheme proved to be a success.[21]

The immediate effects of the new monetary policy were a hardening of the structure of interest rates and a stoppage of the automatic expansion of liquidity in the system through the Reserve Bank's purchases in the open market. A solid base was laid down for the interest structure and it was of special significance that for the first time in the history of the Reserve Bank, its rate became effective in the organised sector of the Indian money market. The Imperial Bank of India stepped up the call rate for advances to banks against Government securities amounting to Rs. 5 lakhs and above from 2¾ % to 3 % and for amounts less than Rs. 5 lakhs from 3 % to 3¼ %. As the season progressed the Imperial Bank further increased the rate of advance by ½ % for both groups of advances. With this increase the Imperial Bank's advance rate against Government securities equalled the Bank rate and even more for smaller amounts, so that it was no longer cheaper for the scheduled banks to borrow from the Imperial Bank than from the Reserve Bank.[22] The inter-bank call money rate moved up to the vicinity of 3 % which was more realistic and consistent with other short rates than the previous artificial ½ % ; other short-rates, which had already gone up in the busy season of 1950-51, went up further to move around the orbit of the Bank rate. Through this harmony in interest rates the money market was brought into the Bank which enhanced the power and the sway of central banking control and the Reserve Bank acquired a greater measure of control than it had ever over the banking system.

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[21] Ibid, P. 18.

[22] Ibid, P. 16.

The financial year 1951-52 was the first year of the Plan and the year stood out as exceptional as it received the full impact of new contractionist monetary policy. First, the deliberate policy of liberal imports resulted in a huge deficit of net Rs. 160 crores (after making adjustment with deficit on Government account) in the balance of payments. This caused a simultaneous contraction of the money supply. Second, the budgetary position of both Central and State Governments showed a surplus of Rs.10 crores. Thirdly, the Reserve Bank, under the constant prodding of the Finance Minister, began to sell securities in the open market. At the end of 1951-52 the Bank's marketable security portfolio declined by Rs. 10 crores. This decline would have been more, but the Reserve Bank had to take up a substantial portion of 3 % 1958 Loan, issued in August 1951, which did not get a good response in the market. The combined effect of all these three factors was a decline in the money supply by Rs. 180 crores, i.e. about 11 % and the national income increased by 4,5 %. Such a big fall in the money supply in one year was bound to have serious repercussions on the price level as we shall presently see.

By January 1952, the decline registered in the money supply was about 13 % compared to what it was at the beginning of 1951-52. The wholesale price index fell from 458 to 430 during the same period, i.e. a fall of about 7 %. Apparently, the economy was resisting a proportionate fall in the price level partly through an increase in the velocity of circulation of money. There were a great demand for liquidity and acute stringency in the money market and all the rates went up in the busy season of 1951-52. But such a situation could not last long expecially in the busy season when the demand for money was not being met and national income was rising. A general commodity price crash occurred in February 1952, right at the peak of the busy season. During the next few months the index of wholesale prices declined from 430 in January to 367 by May 1952, i.e. a decline of about 15 %. This time prices fell more than the decline in money supply and it was mainly due to the role of speculation.

The dishoarding of commodities in expectation of falling prices, led to a steep fall in general commodity prices.

The price crash of February 1952 was looked upon favourably by the authorities, for it heralded the end of a decade-old inflation. The official explanation put the entire blame on "speculative over-trading and heavy accumulation of stocks on certain primary commodities, including some which enter into the country's export market trade."[23] Mr. C.D. Deshmukh claimed that his monetary policy was a powerful check against speculation and it had initiated a correct price policy. However. it is difficult to agree with the merits of the new monetary policy as claimed by the finance Minister. Firstly, it was an exaggeration to attribute the success achieved against inflationary speculation to that part of monetary policy which was associated with the rise in the Bank rate. When the speculative demand for money is met at 20 to 25 % interest, ½ % rise in the Bank rate is irrelevant. [24] This time speculation worked in the opposite direction to that of 1948-51, followed by sagging prices which reduced private investment to a low level. Furthermore during the last year of the Plan when considerable deficit financing was incurred which resulted in monetary expansion and rise in prices, speculation came back in full force, though there was no change in the official Bank rate.

The trend of monetary policy for the first three years of the Plan, i.e. 1951-52 to 1953-54 remained the same and recessionary prices dominated. The net effect of various factors determining the supply of money was a further though smaller decline in money supply in 1952-53 and a very samll rise in 1953-54. During these years, contraction of money supply in the slack season was more than its expansion in the previous busy season. (See Table 20). However, it is not the

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[23] Report on Currency and Finance, 1951-52, P. 168-9.

[24] J.D. Sethi, Problems of Monetary Policy in an Underdeveloped Country, P. 239.

stock of money but the flow of money incomes i.e. the stock of money multiplied by its income velocity, which in conjunction with real income determines the price level. During the first three years of the Plan, real national income increased by 13,8 % ; stock of money declined by 9,3 % and money incomes increased by 10 %. The accompanying increase in the velocity of money was not enough to maintain the old price level. The price level declined by about 15 % over three years. The following tables show the money supply and price level during the First Five Year Plan.

TABLE 21

VARIATIONS IN THE MONEY SUPPLY DURING THE FIRST PLAN PERIOD

(In crores of rupees)

	Outstanding as on March 30, 1951.	1951 - 52	1952 - 53	1953 - 54	1954 - 55	1955 - 56	1951 - 52 to 1955 - 56	Outstanding as on March 30, 1956.
Currency sith the public	1,329	- 119'3	- 227	+ 26'0	+ 88'3	+ 193'9	+ 166	1,505'2
other deposits with the Reserve Bank	26'0	- 6'4	- 31	- 1'8	- 50	+ 2'3	+ 14'0	12'0
Bank Money	620'7	- 53'7	- 18'0	+ 0'9	+ 49'3	+ 68'1	+ 46'5	667'2
T o t a l	1,975'7	- 179'4	- 43'8	+ 25'1	+ 132'6	+ 264'3	+ 198'7	2,184'4

Source : Reserve Bank of India Bulletin, July, 1961.

TABLE 22

INDEX NUMBER OF WHOLESALE PRICES AND COST OF LIVING : 1950-56

(Base year 1939 = 100)

Main Groups	June 1950	April 1951	May 1952	August 1953	December 1953	April 1954	December 1954	May 1955	December 1955	March 1956
General Index	396	458	367	410	389	403	368	342	368	390
Food Articles	403	413	341	407	367	382	318	276	324	313'2
Industrial raw materials	491	683	416	489	459	472	436	396	438	420
Semi-manufactured	336	388	323	365	357	362	347	330	347	369
Manufactured	348	412	371	371	364	381	375	375	373	373
Miscellaneous	692	752	583	706	712	702	580	545	544	546
Cost of living index (1949 = 100)	101	104	105	111	103	102	97	92	98	100

Source : Reserve Bank of India Bulletin, February, 1956

Recessionary trends also dominated the greater part of 1954-56. Prices were falling since April 1954 and monetary policy failed to stop once again a sudden and sharp fall in prices following the coming of winter crop of 1953-54 and then the monsoon crop of 1954-55. These two were bumper crop years and national income in real terms showed the biggest annual increase ever recorded. Prices declined all round, so much so that by May 1955 the general index of wholesale prices reached the lowest level during the Plan period. The fall in prices affected the position of important classes - particularly agriculturalists and subsequently the possition of artisans and small-scale industries. Moreover, the volume of unemployment appeared to be increasing from the middle of the Plan period. The Government's tax programme and borrowing policy also suffered badly owing to the continued recessionary trends. Fortunately, the phasing of the development outlay was such that large scale expenditure began in the last quarter of 1954-55, accompanied by currency expansion through deficit financing. This helped to revive the situation after some time.

In the meantime, there came the important development of the recessionary period, Instead of acting on the prices in such a manner as to maintain some kind of planned relations, the Government used the opportunity to bring about decontrol. Controls on cotton textiles were relaxed in April 1952 and completely abolished in July 1953. Relaxation of controls on food grains began in mid-1952 and by March 1955, all remaining controls were progressively abolished. [25] But the authorities failed to realise that it is easy to dismantle the machinery of control but more difficult to build it particularly in a vast and administratively backward country like India ; and three consecutive good harvests were exceptions, depending on the windfall and uncertain circumstances of good weather. They also failed to appreciate the role of various controls as sup-

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[25] Reports on Currency and Finance, 1953-54, P. 34 and 1954-55, P.25.

plementary to monetary and fiscal policies in a period of rapid economic development.

Now, we shall turn to the monetary policy during the last phase of the first plan period. From the last quarter of 1954-44 money supply started to increase rapidly due to a number of reasons. First, the major projects of the Plan were put into operation involving huge expenditure in this period as originally determined by the phasing of the planned outlay. Secondly, the Government ran into a big deficit in internal account which was accompanied by an expansion of currency. Thirdly, the private sector continued to have surpluses on external account which also meant an increase in money supply. Fourthly, the Reserve Bank reversed its open market policy and resumed purchasing securities in the market because the bill market scheme was not all that successful due to the absence of some other institutional arrangements. For the first time since the beginning of the Plan, the Reserve Bank's portfolio of Government securities began to increase. In the previous four years when other factors were contracting the money supply open market operations also were working in the same direction and, in the last phase of the plan, when the budget deficit and balance of payments were to increase the money supply, the open market operations of the Reserve Bank were doing the same, although the opposite should have been done in each of these phases. The monetary policy of the Reserve Bank was clearly thoughtless, badly organised and misdirected. [26] During the last fifteen months of the Plan the money supply increased by about Rs. 275 crores. Such a big increase in the money supply had its due effect on the price level, though at first slowly. The general index of wholesale prices started to rise from the middle of 1955 and it rose more sharply towards the end of 1955-56. The general index increased from 345 in June 1955 to 402 by the end of the financial year 1955-56 an increase of about 15 % in nine months. The rise was not general or uniform, it was mostly confined to agricultural commodities, and industrial raw materials the prices of manufacture remained relatively stable. The rise in the prices of food

[26] Sethi, Op.Cit, P.242.

articles was the biggest, about 30 % and the rise was also reflected in the cost of living index which rose from 92 to 100 during the same period. The continued price rise was attributed to the decline in agricultural output, especially food grains in 1955-56, a larger export of certain raw materials and the increase in demand resulting from a larger increase in investment outlay and a rise in incomes and levels of consumption. It was also partly due to the return of speculation and hoarding, for the prices were rising and expected to rise further.[27]

It would be of great interest to examine the above analysed monetary policy in the light of the objectives of the Plan. Monetary policy, which led to monetary contraction, pessimistic expectations and uncertainty in the capital market had their due effect on the objectives of the Plan and its targets. The target of investment as fixed by the Planning Commission was very modest. The annual rate of investment was to go up from 5 % to 6¾ % of the national income at the end of the plan period. This proposed increase in investment was to be achieved by ploughing back 20 % of the additional national income during the Plan. But the total ploughing back during the first plan period came to 17 %, including the heavy investment of the last two years, the figure for the first three years was not more than half of the total. During the first three years national income increased at a faster rate than provided for in the Plan while the rate of investment fell short of targets both in the public and private sectors. The real cause of this spectacular rise lay rather in a good monsoon than in the modest and yet unfulfilled investment targets.

For the public sector the ploughing back was to take place mainly through taxation and borrowings and for the private sector primarily through raising equity capital in the market. All these sources suffered considerably because of recessionary trends which dominated the greater part of the plan period. The

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[27] The Reserve Bank of India, Governor's Report, Aug. 1956, P.8.

Planning Commission emphasised the need "to raise the level of the revenue to meet the needs of development". [28] The Central Government imposed substantial taxation in 1951-52, partly for this reason but mainly as a disinflationary measure. Export duties were raised all round in 1950-51 and again in 1951-52. But with the price crash of February 1952 and after, with the decline in the external demand for Indian goods, those export duties had to be drastically cut down. As the recessionary price movement continued, it became difficult for the Finance Minister to impose new taxes, as was planned, to get more resources for investment, inspite of the trends of rising national income. The heavy fall in prices caused a decline in tax revenues in the nest three budgets. The States' tax sources, being inelastic, their revenues were not adversely affected, but failed to show any effect of rising national income. The fiscal-monetary policy of the Government proved to be inconsistent and selfdefeating.

The loan programmes of the Government also suffered badly as a consequence of the onslaught of recession. With contraction of the money supply and the commodity price crash the gilt-edged market position changed from bad to worse. In the first three years of the Plan taking the Centre and States together, repayment of maturing loans exceeded the contribution of fresh loans by Rs. 5 crores. [29] If the commodity prices had either been maintained at a stable level or fallen gradually, accompanied by an increase in the money supply proportionate to the increase in national income, the gilt-edged market would have benefitted a great deal. It was in the last two years of the Plan, when the money supply rose rapidly the Governments were able to raise a total loan of Rs. 205 crores, which exceeded the very low target of Rs. 115 crores for the Centre and the States together.

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[28] The First Five Year Plan, P. 52.

[29] Review of the First Five Year Plan, P. 28.

It was emphasised by the Planning Commission that the prevailing price relationships are the prime factor in the allocation of resources in the private sector and violent fluctuations must be avoided in the interest of the growing private sector. The target of investment in the private sector for the plan period was Rs. 1800 crores, but the actual investment came up to Rs. 1500-1600 crores ; and a great part of this materialised in the last two years of the Plan. Equity prices, which went up sharply during the Korean War boom showed signs of weakness with the commencement of downward price trends from the middle of 1951, and they collapsed in February 1952 following the price crash. The stock markets had to be closed down for two weeks both in Bombay and in Calcutta. Theequity prices did not show any marked improvement during the next two years despite a continuous rise in industrial production, stability of the wholesale prices of manufactured goods and a rapid rise in national income. The revival of the stock market was prevented by the high cost of living, which went up in 1952-53 and in 1953-54 and higher wage bills reduced the level of profits. However, from the middle of 1954 the spread between the prices of agricultural commodities and those of manufactured articles widened in favour of the latter and the cost of living declined. The Equity market was given a stimulus by those two factors, particularly during 1954-56 when the money supply also expanded. Between the middle of 1954 to the end of 1955-56, the index number of variable devidend securities rose by about 11 % [30] and the gilt-edged market received a low preference to the former.

OPERATIONS OF THE RESERVE BANK OF INDIA 1951 - 1956

The new monetary policy, which was announced during the first year of the plan, marked an end of the so-called "consolidation of cheap money policy" and began an era of dear

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[30] The Reserve Bank of India Bulletin, June 1958.

money policy. The Reserve Bank first raised its Bank rate from 3 % to 3½ % in November, 1951. Simultaneously, with the raising or the Bank rate the Reserve Bank announced that during the ensuing busy season it would, except in special circumstances, refrain from buying Government securities to meet the seasonal requirements of scheduled banks, but it would, as a normal practice, continue to grant advances against Government securities under Section 17 (4) (a) of the Reserve Bank of India Act. The Bank also withdrew its support from the gilt-edged market. The immediate effects of the new monetary policy were a hardening of the structure of interest rates and a stoppage of the automatic expansion of liquidity in the system through the Reserve Bank's purchase of securities in the open market. It also made the Bank rate effective and the leading rate in the Indian money market and all other short-term rates began to move around the orbit of the Bank rate. The open market operations of the Bank were relieved from the function which they were not originally intended to serve, i.e. to meet seasonal demand for funds. All these changes made a solid base for the interest rate structure and introduced logic and consistency into monetary policy and central banking operations. Here, we shall examine the loans and advance policy and open market operations of the Reserve Bank in the light of the changes made in the monetary policy with the commencement of planning.

LOANS AND DISCOUNTS POLICY OF THE RESERVE BANK : THE Bill Market Scheme :

The loans and discount operations of the Reserve Bank underwent a fundamental change with the introduction of the Bill Market Scheme, which became a part of the new monetary policy though it came much later. Following the changes in its open market policy, the Reserve Bank introduced the Bill Market Scheme in January 1952 as an alternative mode of accomodation to the banking system which would be more suited for a qualitative control of credit expansion than advances against securities. [31] While the question of creating a bill market so as

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[31] The Reserve Bank of India Bulletin, September 1955.

to facilitate such control had time and again received the attention of the Reserve Bank in the past, it was brought into the forefront by the above mentioned developments ; and the Bank, in consultation with the several representative bankers in Bombay and Calcutta, evolved the Bill Market Scheme in January 1952. The Scheme, which was introduced as an experimental measure, received satisfactory response during the first year and it was subsquently made a permanent feature of the Indian money market.

The Bill Market Scheme followed, in broad principles, the system that existed before the establishment of the Reserve Bank. Through this system the Imperial Bank of India under Section 14 of the Indian Paper Currency Act, 1920, could borrow during the busy season, funds up to Rs. 12 crores from the Currency Department against internal bills or hundis drawn for financing bona fide trade or by the conversion of advances granted for the same purpose. The salient features of the Scheme, as originally formulated by the Reserve Bank, were as follows : [32]

a) The Reserve Bank undertook to make demand loans at its banking offices in India to scheduled banks against their promissory notes supported by usance bills or promissory notes of their constituents. Section 17 (4) (c) of the Reserve Bank of India Act permitted the Reserve Bank to make advances against bills of exchange and promissory notes drawn on and payable in India and arising out of bona fide trade or commercial transactions bearing two or more good signatures (one of which was to be that of a scheduled bank) and maturing within ninety days. As banks normally finance business through loans, cash credits and over-drafts, they were allowed to convert a part of the borrowings (representing the minimum requirements of the borrower during the next three months) into usance promissory notes of ninety days which they could lodge with the Reserve Bank as collateral for advances.

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[32] Reserve Bank of India, Governor's Report, August 1952, P. 17-18.

b) As an inducement to banks to popularise the bill as an instrument of credit, the Reserve Bank offered to make advances against bills at a half per cent below the Bank rate, i.e. at 3 % per annum. As a further incentive, the Bank agreed to bear half of the cost of the stamp duty incurred in converting demand bills into time bills. [33]

c) The minimum value of individual bills tendered to the Bank was fixed at Rs. 1 lakh each, while the minimum limit of a single advance which a bank might take at any time was fixed at Rs. 25 lakhs.

The banks were thus enabled to minimise internal charges by borrowing according to their needs and by remitting spare funds to reduce their indebtedness. For the consttiuents of the banks the scheme combined the advantages of the cash-credit system with those of the bills of exchange, permitting the borrower to make withdrawals and repayments into the account as often as before. Thus, the Bill Market Scheme presented an attempt to fit the existing banking practices into the requirements of the Reserve Bank of India Act.

The Scheme was provisionnally restricted to banks whose deposits were not less than Rs. 10 crores. This reservation was mainly in order to avoid the delays which would result if the Scheme were to be extended to include smaller banks and smaller bills within its scope. Not withstanding the initial difficulties in the first few months of its working, the Scheme proved to be a success as revealed by the following table :

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[33] The Indian Central Banking Enquiry Committee had recommended that the rate for loans against authorised securities should be higher than the rate for bills and it would be useful to have a larger margin between these two rates at the outset. It also recommended the abolition of stamp duty on bills. The State Governments were not, however, in favour of it. The Report, 1931, p. 401-402.

TABLE 23

GROSS ADVANCES (i.e. EXCLUSIVE OF REPAYMENTS)

MADE BY THE RESERVE BANK

(in crores of rupees)

Last Friday of	Under Section 17(4)(a) (against Government Securities)	Under Section 17(4)(c) (against bills under the Scheme)	Total Advances
1951	76.57	---	76.57
1952	164.25 (66.80)	81.45 (33.20)	245.70
1953	129.58 (66.30)	65.84 (33.70)	195.42
1954	188.70 (56.20)	147.52 (43.80)	336.21
1955	199.70 (47.10)	225.44 (52.90)	425.38
1956	466.95 (51.66)	436.82 (48.34)	903.77

Figures in brackets indicate percentage of total advances.
Source : Trends and Progress in Banking in India, 1959.

Loans outstanding against bills touched a peak of Rs. 29.6 crores on May 10, 1952, and upto June 30, 1952, a gross amount of Rs. 74 crores had been borrowed. However, theamount of borrowings from the Reserve Bank against bills showed a decline in 1953. This was mainly due to the continued recession and also due to comparatively easy-money conditions in the 1952-53 busy season. Borrowings against bills showed a slight improvement over the past year. It was represented by the Indian Bank's Association that, under the conditions for eligibility imposed under the Scheme, only a few big banks could take advantage of the Scheme. It was, therefore, decided in June 1953 to extend the facilities to scheduled banks having deposits of Rs. 5 crores or more. In July 1954, the Reserve Bank, at the recommendation of the Committe on Finance for Private Sector [34] further extended the Scheme to all scheduled banks, irrespective of the size of deposits and also reduced the minumum limit of a loan to Rs. 10 lakhs and the minimum amount of each individual bill to Rs. 50,000. With the relaxation of eligibility rules more banks were in a

[34] Report of the Committee on Finance for Private Sector, P. 56-57

position to take advantage of the Bill Market Scheme. The amount of gross advances against bills continued to increase from the 1953-54 busy season onwards and reached a record figure of Rs. 467 crores in 1956 and exceeded the amount of gross advances against Government securities.

The increasing amount of borrowing under the Bill Market Scheme led the Reserve Bank to claim that "the Scheme had been a striming success" and that "banks had been making full use of the Scheme to provide themselves with funds during the busy season".[35] However, the success of the Scheme was a temporary affair rather than a real success and from 1957 onwards the Scheme nearly collapsed for several reasons,

CHANGES IN OPEN MARKET POLICY AND MARKET BORROWINGS

It has been noted in the previous chapter the dilemma of the consolidation of cheap money policy under which open market operations of the Reserve Bank became a mechanical affair and the uncertainty of rates nearly ruined the gilt-edged market. The old policy also defeated the purpose of disinflationary measures by releasing new currency, particularly in the midst of inflation. Mr. C.D. Deshmukh, who became Finance Minister in June 1950, was determined to end the self-defeating open market operations of the Reserve Bank and to introduce definiteness and certainty to monetary policy in the place of the slow drift and uncertainty of his predecessors. However, due to his extreme moderation, it took him nearly one and a half years to formulate the new monetary policy, although he reversed the policy of purchase to sale of securities during the Korean War boom. While the uncertainty of rates and the boom continued the institutional investors unloaded Government securities and the Reserve Bank kept on pushing up the sale. These made the gilt-edged both unpopular and unstable, which continued during the first year of the Plan.

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[35] Press Communiqué issued by the Reserve Bank of India on Feb 3. 195

The new monetary policy was announced in November 1951 and rejected the old policy in no uncertain terms and introduced a clearly defined policy of dear money. First, the Bank rate was raised from 3 % to 3½ %, which was neither expected nor had any justification, but served the purpose of removing the uncertainty of the rate of interest. Further the Finance Minister repeatedly gave firm assurances that the prevailing rate should be maintained. The market was genuinely expecting a lower rate in view of the price recession and the lowering of the rate by the Bank of England. The rise in the Bank rate in November 1951 closely followed a rise in the Bank rate in England ; consequently, subsequent changes in the Bank on England's rate [36] created expectations of similar changes in the Indian rate. Mr. Deshmukh maintained the rate fixed at 3 ½ %, which gave much needed certainty to the market.

Once a fixed rate of interest had been decided upon, open market operations became the main weapon for monetary control. The logic of a fixed high Bank rate demanded that open market operations should be conducted towards the expansion of money supply during recession and the process should be reversed during inflation. But the monetary authorities in India failed to apply this fundamental principle of monetary management. The Reserve Bank, under the insistence of the Finance Minister, continued selling securities even after the price crash in February 1952. Again, in the last year of the Plan when inflationary forces reapeeared, strangely enough, the Reserve Bank started to purchase securities. [37] One finds a lack of judgement and foresight on thepart of the monetary authorities.

Other aspects of the new monetary policy were that the Reserve Bank was no longer ready to purchase securities whenever offered for sale and, at the same time, the Bank was

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[36] The Bank rate in England was reduced from 4% to 3½% in Sept. 1953 and no further to 3% in may 1954 as the situation in 1953 and 1954 was one of recession following the Korean War boom.

[37] The Reserve Bank's holdings of marketable securities were : Rs.310 crores in 1950-51, 300 cr. in 1951-52, 286 cr. in 1952-53, 235 cr. 1953-54, 185 cr. in 1954-55 and 233 cr. in 1955-56.

prepared to grant loans and advances against Government securities and usance bills to meet the seasonal demand for funds. These changes not only made the Bank rate effective almost for the first time in the organised sector of the Indian money market but created a solid base for open market operations. These operations theoretically and institutionally ceased to be a perennially mechanical affair and could be used only when required and the normal finance for trade and industry was divorced from those operations. In this way open market policy ceased to be encumbered by the functions which were outside its scope. [38] All these changes enhanced the utility and effectiveness of open market operations as instruments of monetary policy. However, it is a different matter that the Reserve Bank used these operations for the purpose of monetary deflation. But it goes to prove that with correct monetary policy, open market operations could be made more effective even under Indian circumstances.

The success of the open market operations is generally reflected in the level of fluctuations in gilt-edged prices. The gilt-edged market slumped heavily following the rise in the bank rate and the Reserve Bank's withdrawal of support from the market. The 3 % Conversion Loan which was being supported at Rs. 93 since December 1950 declined to Rs. 79.37 at the beginning of December 1951. It was feared that any further decline sould have serious repercussions on the market and it was decided to support that loan at Rs. 80. This support to the market it may be noted, was partial and discriminatory. In fact, throughout this period since November 1951, except for strategic support, gilt-edged prices were, by and large, allowed to find their own levels. [39] The gilt-edged market reached its lowest level by September 1952, correspondingly the yields hardened. However, from September 1952, the gilt-edged market remained not only stable but also firm inspite of the pressure of sale

[38] J.D. Sethi, op. cit. P.225.

[39] "Open Market Operations of the Reserve Bank of India", The Reserve Bank of India Bulletin, June 1960.

maintained by the Reserve Bank. Another sign of the success of open market operations could be located in relation to other security prices. [40] Generally the trend in equity prices is reflected in the gilt-edget price, but the fluctuations in the former were wide and violent while in the latter, after the initial fall, were within narrow limits,as shown in the following table.

TABLE 24

INDEX OF SECURITY PRICES 1950-51 to 1956-57

Base Year 1949-50 = 100

Average Price Index

Y e a r	Government and Semi-Government securities	Ordinary Shares
1950-51	98.2	108.9
1951-52	94.1	112.0
1952-53	90.1	94.0
1953-54	90.4	95.6
1954-55	90.5	112.9
1955-56	90.9	121.6
1956-57	90.5	121.2

Source : The Reserve Bank of India Bulletin, June 1958.

Another important achievement was that banks continued to maintain a non-fluctuating investment portfolio. Normal average liquidation of Government securities before the Plan period was between Rs. 50 and 60 crores in busy seasons. Since then not only these liquidations became negligible in the busy season, but the purchases by banks in the slack season increased considerably. This feature was also due to a shift in the asset preference schedule of the market owing to the continued recession. However, the old tendency to liquidate securities reappeared in 1955-56 and in subsequent years, although in not

[40] And vice versa

so acute a form as before the Plan. This was due to the speculative demand for money.

The loan programme of the plan period provided an interesting study. At the time of the formulation of the Plan the outlook for market borrowings was far from encouraging, the market in fact was so weak that there was pressure on the Reserve Bank to support it. The Planning Commission, however,did not assess independently the possibilities of future borrowings in the light of its own recommendations, viz. planned investment on a large scale, new organizational changes in the market, deficit financing and the role of an integrated system of controls, etc. Nor were these factors taken into account by the Reserve Bank or by the Finance Minister, on whose advice the Commission made estimates of market borrowings, Consequently, the Commission formed a very modest target of Rs. 115 crores of total net borrowings over five years ; of this Rs. 36 crores were for the Centre and Rs. 79 crores for the States. Annual net Central borrowings of Rs. 7 crores were very low by any standard. It is of some interest to note that during the last two years of the World War II weekly net borrowings amounted to Rs. 5 to 7 crores.[41] Such a low borrowing programme is all the more baffling when the expected rise in income is taken into account.

TABLE 25

MARKET BORROWINGS DURING THE FIRST PLAN PERIOD

(In crores of rupees)

	1951-52	1952-53	1953-54	1954-55	1955-56	1951-56
Centre	- 34.2	- 0.9	- 37.2	87.0	34.3	49.0
States	11.4	16.6	39.6	32.7	55.1	155.4
Net Borrowings	- 22.8	15.7	2.4	119.7	89.4	204.4

Source : Review of the First Five Year Plan, p.44.

41. The Reserve Bank of India, Report on Currency and Finance; 1945-46, P. 71.

Although the Central government was able to raise more loans than the Plan targets, it could hardly be considered as a great achievement since the original target was too low, In all the years of the Plan except 1954-55 loans raised from the market fell short of those budgeted at the beginning of the year. During the first three years of the Plan Central government's total outgoings on loans exceeded the total receipts by Rs. 75 crores. The States, however, were able to put through moderate borrowing programmes in the first two years and were able to step them up in 1953-54. In the first three years of the Plan taking the Centre and States together, repayment of maturing loans ecceeded the contributions of fresh loans by Rs. 5 crores. The last two years' borrowings not only made up that loss but exceeded the original target by Rs. 90 crores. These changing phases in market borrowings reflected monetary contraction during the first phase of the Plan and its expansion during the last phase of the Plan period.

However, it was in the technique and methods of debt management such as the terms and timings of new loans and the crystallization of market preferences that the Reserve Bank showed greater skill. The success of the various loans and rising demand for the gilt-edged securities could be attributed to this skill. The Reserve Bank successfully maintained the same interest rate for the same types of loans and also improved the terms of new loans in its favour.For example, the rate of interest on medium-term loans --all loans issued in this period were medium-term-- remained at 3½ % throughout. But the issue price and maturity of loans gradually improved as revealed in the following table.

TABLE 26

LOANS RAISED BY THE CENTRAL GOVERNMENT

DURING 1950-51 to 1955-56

Name of the loan and month of issue	Maturity years	Cash*	Conversion*	Total receipts*	Issue Price
August 1951, 3% 1958	7	12.8	37.6	50.4	-
1952-53	-	-	-	-	-
June 1953, 3½ % 1967	8	23.0	52.0	75.0	98.4
April 1954, 3½ % 1964 NPL	10			158.1	
July 1955, 3½ % 1966 NP Bonds	10	45.7	58.0	163.7	98.8

* In crores of rupees

Source : Annual Reports on Currency and Finance, 1951-52 to 1955-56, Sections on Public Debt.

Another important step was that a large part of the new loans was taken up by the Reserve Bank specifically for the purpose of resale to the market. As the demand for gilt-edged increased, the Reserve Bank reduced its own investment in new loans ; it declined from 30 % in the case of the first loan to 24 % in the case of the last loan. The Bank aslo started buying maturing loans and thereby technically pre-arranged the success of a new loan. All these actions gave the Reserve Bank a commanding position over the market and made the debt management more effective.

During this period, inspite of the success in market borrowings the Reserve Bank did not issue a single long-term loan. This was a matter of deliberate policy because of a suspicion that a long-term loan was bound to be a failure. It was true that the market preferred short and medium term loans, which is another feature of all underdeveloped money markets. Too much concentration on short and medium term loans could prove most embarrassing for future borrowings and it is the task of the monetary authorities to develop a balanced maturity

pattern of public borrowings. Long-term loans are indispensible for long-term planned investment programme. The imbalance was rectified to a large extent during the Second Plan period.

CHAPTER VII

MONETARY PROBLEMS OF THE SECOND FIVE-YEAR PLAN

The Second Five Year Plan had been described by Mr. Nehru as "the first real planning in India" in contrast with the First Five Year Plan which was a "modest approach to planning" [1] - not more than a programme of public expenditure designed to strengthen the economy and to initiate changes necessary for steady economic development. In the first Plan most of the expenditure was devoted to improvements in agriculture, irrigation and power, the transport system and social services. But there was no large-scale public investment in the industrial sphere and no special view was taken of the pattern of industrial development of the country. The Second Five Year Plan was meant not only to carry forward the process initiated in the first Plan but also was intended to lay the foundations of industrial development and to accelerate institutional changes leading the economy towards the "take off" stage by the end of the Third Five Year Plan.

The Second Five Year Plan was faced with a barrage of criticism right from the beginning both at home and abroad, and no sooner had the Plan been started when the authorities were involved in serious difficulties regarding its implementation. The Plan also raised far-reaching questions concerning the technique and organisation of planning in India ; and all these were not without their monetary implecations. Under such circumstances it would be appropriate to discuss, in brief, the salient features of the second Plan - its objectives and

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[1] Reported in the Hindu, May 4, 1958

targets and some of the major difficulties and problems that the Plan had had to face. Then we shall analyse monetary implications of the Plan and operations of the Reserve Bank during the second plan period.

1. OBJECTIVES OF THE SECOND FIVE YEAR PLAN

The Second Five Year Plan was formulated with reference to the following objectives : [2]

a) "a sizeable increase in national income so as to raise the level of standard of living in the country;

b) rapid industrialization with particular emphasis on the development of basic and heavy industries ;

c) a large expansion of employment opportunities ;

d) reduction of inequalities of income and wealth and a more even distribution of economic power".

To these objectives was added the promotion of a "socialistic pattern of society" ; a phrase which no one cared to define clearly ; probably the concept does not admit that clarity. [3]

The Second Plan aimed at an increase in national income by 25 % during the plan period. In other words, the annual rate of growth was calculated to be 5 % on an average ; this was roughly double of the plan rate during the First Plan. Per capita income was expected to go up from Rs. 280 in 1955-56 to Rs. 330 by 1960-61 - an increase of 18 % during the Second Plan as against the plan increase of 10 % during the previous Plan. It was estimated that the national income would rise from Rs. 10,800 crores in 1955-56 to Rs. 13,480 crores in 1960-61 - an increase of Rs. 2680 crores at 1952-53 prices. [4] However, after making proper allowance for the population growth, the rise in real national income was not more than 3 % per annum.

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[2] Government of India, Planning Commission, The Second Five Year Plan, New Delhi, 1956. p.24

[3] "Socialism, in short is like a hat that lost its shape because every body wears it." C.M. Joad, Modern Political Theory.

[4] The Second Five Year Plan, p.9.

In order to achieve the above mentioned target the total outlay proposed for the public sector during the Second Plan was of the order of Rs. 4800 crores, of which Rs. 3800 crores represented investment and Rs. 1000 crores were what may be called current development outlay. Investment in the private sector was put at Rs. 2,400 crores, the total aggregate investment being Rs. 6,200 crores for the plan period. The average productivity of investment to capital output ratio turned out to be 1.8 : 1 during the First Plan owing to a number of favourable factors, However, to be on the safe side, the capital-output ratio for the Second Plan was kept at 2.3 : 1. As income would grow at double the rate of the previous plan, it was expected that the required amount of savings would increase at the same rate. It was envisaged that the ratio of savings to national income would rise from 7 % in 1955-56 to 11 or 12 % in 1960-61. [5]

The following table shows a break-down of development expenditure in the public sector under major headings :

TABLE 27

PLAN OUTLAY AND ALLOCATION OF RESOURCES IN THE SECOND PLAN

	In crores of rupees			Percentage of the total Outlay
	Investment Outlay	Current Outlay	Total Outlay	
1. Agriculture and Community Development Projects	338	230	568	11.8
2. Irrigation and Flood Control	456	30	486	10.1
3. Power	407	20	427	8.9
4. Industries and Mining	790	100	890	18.5
5. Transport and Communications	1335	50	1385	28.9
6. Social Services, Housing and Rehabilitation	455	490	945	19.7
7. Miscellaneous	19	40	99	2.1
T o t a l	3800	1000	4800	100.0

Source : The Second Five Year Plan, p. 56.

[5] Ibid. p. 9-10.

The total outlay in the industrial sector in the Second Plan was stepped up by five times the amount of the first Plan, the percentage increase being from 8 to 19. Industries producing capital goods and certain intermediate products, especially iron and steel, heavy and electrical engineering, basic chemicals and transport equipment were regarded as the basic and heavy industries in the Plan and high priority was accorded to these. Of total public investment in the industrial sector, six-sevenths was to be for the establishment of capacity for the production of capital goods. This together with the expenditure in power and transport, which was directly related to the heavy industrial programme, constituted 56 % of the total plan outlay. Although there was an increase in expenditure in the agricultural sector in absolute terms, the percentage outlay declined from 32 % in the first plan to 22 % in the second Plan. Expenditure on the social services in the present plan was nearly double that on the previous one, but in terms of percentage it showed a decline over the last Plan. Thus, although the second Five Year Plan was in a sense, a continuation of the development efforts commenced in the First Plan, a shift in priorities in favour of industrialization, especially the development of heavy and basic industries was unmistakable.[6]

In so far as the employment opportunities were concerned, the Plan visualised an additional employment of 8 million workers in the non-agricultural sector. The agricultural sector was expected to absorb about 2 million labourers. Broadly speaking, the Plan estimated to provide for as many a jobs as were required by the new entrants in to the labour du-

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[6] Heavy emphasis on industrialization together with the undefined concept of a "socialistic pattern of society" led some economists to believe that it was a soviet-type plan. A. Shonfield, International Affairs, July 1957. p.301.
P.T. Bauer, Indian Economic Policy and Development 1961.
However, a large number of economists disagree with the abovementioned view. Notable among these are : Max. F. Millikan and W.W. Rostow, A proposal, 1957, p.61.
J.K. Galbraith, "Rival Economic Theories in India", Foreign Affairs, october 1958 and W. Malenbaum "India and China : Contrasts in Development Performance", American Economic Review July 1959.

ring the second plan period. 7 However, it had not been found possible to reduce the areas of unemployment of the order of 5 million accumulated during the First Plan period. A rise in the level of activities in the small-scale and village industries was expected to provide some relief to the under-employment in the agricultural sector.

In order to reduce the inequalities of income and wealth and to quicken the pace towards a more egalitarian pattern of society the Planning Commission proposed a number of measures such as a steeper progression of income tax and estate duties, a small annual tax on wealth and taxation of higher incomes on the basis of expenditure rather than on income. It also pressed for accelerating the pace of land reform, especially in regard to matters concerning ceiling on holdings. [8] The Commission assigned a definite and dynamic role to the small-scale and cottage industries in the second Plan.[9] First they would form the basis of a decentralised society and help to reduce the evils arising out of concentration of economic power in the organised large-scale industries. Secondly, because the Plan in its preoccupation with rapid industrialization and the production of capital goods, neither would enlarge the supply of consumer goods in the short-run nor would absorb any large quantities of labour, it was left with the labour intensive small-scale and cottage industries to absorb a part of the vast unemployed and underemployed labour force to produce as much consumer goods as possible. Thus, the Plan aimed at the optimum rate of growth combined with maximization of output and employment.

We have noted the broad lines of advance contemplated in the second Plan in regard to the achievement of the stated objectives. It would be interesting to mention the method of financing the public sector outlay as envisaged by the Planning Commission. The Plan expected to obtain the total resour-

7 The Second Five Year Plan, p. 115
8 Ibid, p.194-5.
9 The Second Five Year Plan,p.431-2. The Plan made a provision of Rs. 200 crores for the development of small-scale and cottage industries,

ces of Rs. 4800 crores for the public sector through the following methods : surpluses from current revenues were expected to yield Rs. 800 crores, including additional taxation of Rs. 450 crores ; borrowings from thepublic were calculated to supply Rs. 1200 crores ; contributions from the railways and miscellaneous funds were put at Rs. 400 crores ; external assistance would amount to Rs. 800 crores ; and deficit financing would provide Rs. 1200 crores. The Commission, however, left an uncovered gap of Rs. 400 crores,[10] with a warning that the Second Plan would strain the financial resources of the country. The Commission emphasised the need for maximum mobilization of non-inflationary finance. They also recognised need of direct allocation and controls and application of monetary and credit measures to obviate the danger of inflation. Finally, the Commission made it clear that the development programme could not be slowed down or abandoned at the first appearance of bottlenecks and difficulties.[12]

Problems of the Second Plan :

Although the Planning Commission was apprehensive of a certain amount of difficulties in regard to the implementation of the Second Five Year Plan, the problems of the Plan far exceeded the worst expectation of the planners.This was partly due to the defective technique and methodology of planning but mainly due to the gross neglect of organisational aspect of the plan : and as Mr. J.K. Galbraith pointed out it was in the organisational task that "the Indian leaders are being least guided by experience and reflecting least deeply on their courses." [12] So much so that the planned expenditure had to be cut-down twice and the Commission was critised for two opposite reasons : that the Plan was too ambitious and that it did not attempt to do much. Both views were correct in a way, for expenditure was heavy while output was low. The situation became so chaotic by the middle of 1958 that discontent reached the high-water mark and some members of the Indian Parliament asked for

10 Ibid, P. 77-78, and also see Table 35.

11 Ibid, p. 38-39.

12 Cited by J.D. Sethi : Problems of Monetary Policy in an Underdeveloped Country, p. 270.

the dismissal of the Planning Commission. Inadequacies of techniques, organisational deficiencies, corruption and wast became obvious complaints.

The Second Plan envisaged to utilize the long-period advantage of "unbalanced growth" but the methodology of planning and the form of arriving at income, investment and the savings estimates were that of a model of balanced growth.[13] Yet the Plan was incomplete in so far as the technical and organisational requirements necessary to ensure steady and balanced growth of the economy were concerned. The planners should have realised that a large-scale deliberately geared plan of steady growth required a detailed working of the individual projects and of suitable technique and startegy. This in turn involved elaborate machinery and organisational set-up and administrative staff readily available for the implementation of the Plan and to counter-act any adverse situation therefrom.[14] But nothing of the sort was provided for in the Plan and most of the policy recommendations of the Commission were stated in vague terms. Consequently, when those recommendations of the Commission were stated in vague terms. Consequently, when those recommendations were attempted in the face of mounting economic and financial crises they were doomed to failure.

It would be appropriate to mention here that at the time of the formulation of the Second Plan there was considerable discussion in the country about the relative merits of financial planning as against physical resources planning. If the planning is something more than broad programming, it becomes necessary to work-out in detail implications of development efforts in terms of factor allocation and product yields. It should have been clear to the Planners that a large-scale deliberate growth creates disproportionalities between income

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[13] C.N. Vakil and Brahmanand, Planning for an Expanding Economy, 1956, p. 57.

[14] For the organisational task and administrative difficulties of balanced growth see A.O.Hirschman, the Strategy of Economic Development, 1958. Chap 3

and expenditure, between money supply and prices ; it precludes any automatic equilibrium between the demand and supply of commoditees through the free marketprice mechanism. The problem was to create balance in the Plan in terms of real resources and financial provisions and not to allow the price mechanism under the pressure of above mentioned disproportionalities, to strain these resources and also not to allow deliberately created imbalance to be resolved in market equilibrium through free market transactions. Othersise, it would be an invitation to open inflation. But no effort was made to correlate the planning efforts in relation to current availability of real resources : the Plan was substantially a financial plan.

However, it must be admitted that if the primary emphasis is on physical resources planning, it required total mobilisation and direction which was not considered as possible except in a totalitarian regime. But if the development process was not to be abandoned or slowed down and if the burden of development was to be equitably distributed, the role of control of essential commodities, as a judicious mixture of the two approaches became paramount. It was the only way out of the conflict between physical and financial planning. But the Planning Commission treated the issue as a choice of alternatives between overall fiscal and monetary policies on the one hand and the use of devices like import and export control, licencing of trade and industries, price control, and allocations on the other. The Commission favoured a combination of both with an obvious preference for the former group of measures. Regarding the latter measures no specific proposal of formulation of policy was made, no direction or provision for organisational set-up was given. For example, the Planning Commission recommended State trading in food grains but without giving necessary direction for the creation of the elaborate machinery that was required to implement the recommendation. The result was that when during the food crisis of 1953 State Trading was introduced there was no organisation available for it, nor could it be created overnight, and the whole project collapsed to the utter disgust of everybody and to the great

satisfaction of anti-planners. Similarly, the Second Plan, with its heavy emphasis on industrialisation, expected that the labour-intensive small-scale and cottage industries would supply a larger volume of consumer goods. But when the shortage of consumer's goods became acute, the small-scale and cottage industries were nowhere in the picture. There was no attempt to regulate the flow of private capital towards this sector and there was no proper direction, organisation and coordination of the activities of the small-scale and village industries. Maximization of ouptut and employment, decentralization of society : -- all these high objectives were dependent on the village industries for which there was no proper organisation. The broad structure of the Second Plan appeared sound, balanced and logical, but in its actual implementation the Plan was chaotic.

The problem of financing the Plan was also equally chaotic. Within a few months of its commencement the Plan had to be revised due to foreign exchange difficulties and difficulties on the price front. The Plan expenditure was cut down to Rs. 4,500 crores and in the earlier part of 1958 it was further slashed to Rs. 4,260 crores, i.e. Rs. 3,500-3,800 crores in real terms at 1951-52 prices. Cost estimates of all projects went up due to a rise in prices, waste and administrative inefficiency. Now the emphasis was on the completion of the "core projects" of the Plan. [15] A fall in agricultural production, and shortage of foreign exchange were the causes of the crises, which were enumerated as uncertainties by the Planning Commission. But it evolved no strategy to meet such contingencies.

A plan of the size of the Second Plan required a bigger effort and resource mobilization and even a certain reduction in consumption. But all that was provided for in the Plan was that half of the development outlay was to be raised through taxation and borrowings (see table 29), and the other half was

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[15] Government of India, Planning Commission, Appraisal and Prospect of the Second Five Year Plan, May 1958, p.3.

to come from foreign assistance and deficit financing -- both of which were full of uncertainties and danger and were capable of straining the economy further. What actually happened was much worse. The Central Government's revenue account remained more or less static and the States, as usual, failed to raise their share of development expenditure. The recommendations of the Finance Commission caused a transfer of payments from the Centre to the States to increase from Rs. 160 crores to about Rs. 250 crores, partly due to the reorganisation of the States in 1957-58. [16] Initially, external assistance fell short of the targets and there was a substantial short-fall in market borrowings and collection of small savings. For the first two years internal sources could not raise more than Rs. 656 crores and budget deficits, mainly on capital account, amounted to about Rs. 750 crores, [17] although the Plan provided for a larger part of the deficits to be incurred during the last two years of the Plan. Foreign assistance during the first two years came upto Rs. 138 crores [18] whereas the rush for imports led to a total deficit of Rs. 788 crores in the current account and a heavy drain on Sterling reserves (see Table 28). All these raised grave double as to the feasibllity of the reduced target of Rs. 4,260 crores of development outlay. The Planning Commission was under heavy fire from all directions and there was clamour in certain quarters for cutting the planned expenditure further. By now it was clear to many people that further slashing of the Plan could not be done without defeating the aims of India's economic development. Fortunately, at this crucial moment the economy and the Plan itself was lifted out of the crisis by foreign assistance.

As more and more foreign aid flowed in a few steps were deliberated to meet the situation. First, drastic import cuts were advocated and immediately introduced, for there was no other choice left in the face of the rapid erosion of foreign

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[16] The Report of the Finance Commission, 1957

[17] Reports on CurrencY and Finance, 1957-58, p.1.

[18] One reason of the samllnes of foreign aid was the dislike of the size and structure of the Plan by the U.S. Govt. and the World Bank.

exchange reserves. Second, it was necessary to place food production on an emergency basis. It was stated that "behind the inadequacies of financial resources lies the major limiting factor of development, i.e. food production. [19] A committee was appointed, which recommended the need for stepping up production, but also emphasised that there was little current shortage, taken along with normal imports and that the main problem was speculation and hoarding. [20] The absence of controls had provided an invitation to hoarders and speculation and the Committee recommended State trading in food grains, which was introduced but very soon collapsed as mentioned earlier. Third, further deficit financing was to be curtailed and was not to be allowed to exceed the original target of Rs. 1200 crores for the Second Plan period. Fourth, it was emphasised to step up taxation and borrowing programmes. Finally, the need for economy and elimination of wastes in construction was stressed.

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[19] Appraisal and Prospects, p. 26.

[20] Report of the Food Grains Enquiry Committee, 1957.

TABLE 28

BALANCE OF PAYMENT POSITION : 1956-57 to 1960-61

(In crores of rupees)

	1956 - 1957	1957 - 1958	1958 - 1959	1959 - 1960	1960 - 1961
Import c.i.f.					
a) Private	811'9	695'1	504'8	508'I	621'7
b) Government	287'6	509'1	524'8	416'4	478'5
Total Import	1'099'5	1'204'2	1'029'6	924'5	1'100'2
Exports	635'2	594'7	575'9	623'2	630'5
Trade Balance	- 464'3	- 609'5	- 453'7	- 301'3	- 469'7
Official Donation	39'5	32'7	34'4	37'1	46'4
Other invisibles (net)	112'5	100'9	91'7	81'6	36'2
Current account (net)	- 312'3	- 475'9	- 327'6	- 182'6	- 387'1
Errors and omissions	+ 1'6	- 4'1	- 21'7	- 15'7	- 10'7
Official Loans	30'7	92'3	218'6	160'6	249'6
Other Capital Transactions	58'7	127'8	88'4	21'6	88'9
Movement in foreign exchange reserves (increase & decrease)	- 221'3	- 259'9	- 42'3	- 16'1	- 59'3

Source : Compiled from the Balance of payment section of the Reports on Currency and Finance, 1956-57 to 1960-61.

The foreign exchange crisis proved to be a blessing in disguise, for not only did it impart stability and planning element to our import policy but it also brought unexpectedly a high level of foreign assistance. Foreign aid amounted to Rs. 138 crores in the first two years of the Plan and this rose to an annual average of Rs. 300 crores for the remaining years of the Second Plan, bringing the total to Rs.1090 crores for the Second Plan period. [21] The domestic borrowing programme was intensified and proved to be successful beyond expectation, the tax-net was extended and monetary measures, particularly selective credit controls were adopted to check speculation and hoarding. Budget deficits were increasingly met from external resources with some anti-inflationary effect as well as causing less expansion of money supply. In this respect the role of commodity assistance under the U.S. Public Law 665 and especially 480 had been extraordinary ; it took care of our difficulties in the food front, the importance of which could hardly exaggerated.

With the increased amount of foreign assistance forthcoming and improved resource prospects at home, the Plan was revised from Rs. 4260 crores to Rs. 4500 crores and then to the original target of Rs. 4800 crores. However, an ex-post analysis showed that the total expenditure fell short by Rs. 200 crores and total development outlay during the Second Plan period amounted to Rs. 4600 crores. The following table shows the original estimates of resources and actual mobilization or resources for the Second Five Year Plan :

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[22] Appraisal and Prospects, p. 17.

TABLE 29

MOBILIZATION OF RESOURCES FOR THE SECOND PLAN

(In crores of rupees)

	As initially estimated	Es-post
1. Balance from current revenue (on the basis of existing taxation)	350	50
2. Contribution of Railways	150	150
3. Market borrowings (net)	700	780*
4. Small Savings	500	400
5. Providend fund, steel equalization fund and balance of miscallaneous capital receipts over non-Plan disbursement	250	230
6. Additional taxation including measures toincrease	450	1052
7. Budgetary receipts corresponding to external	800	1090**
8. Deficit financing	1200	948
9. Gap	400	---
T o t a l	4800	4600

* Including investment by the State Bank out of P.L. 480 funds.
** Including investment of P.L. 480 funds by the Reserve Bank in 1960-61.

Source : The Third Five Year Plan, p. 95.

The foregoing difficulties also indicated the basic unresolved dilemmas of Indian economic development through planning. If one-half of the resources for development was to come from foreign assistance and deficit financing, then future economic planning would be precarious. The economy is now faced with the crucial paradox of the "take-off stage" and a conflict has emerged between the organic self-sustained growth and its artificial implementation through foreign aid and deficit financing. With the commencement of the Third Five Year Plan India has entered into a crucial stage. It is possible that monetary

aspect of the take-off stage may superficially appear to have been tackled and yet it is far from the reality. The price line has obviously not been held ; the general index of wholesale prices increased by 30 % during the Second Plan. Food production remains a perennial problem of our economic development. Some day the extraordinary imports under P.L. 480 will have to end, and if they do not continue to serve us for the next ten or fifteen years we shall be back at the old question, viz. can we do without internal control over supply and distribution. The answer to this question is obvioulsy in the negative. For no artificial prop can sustain planning for long. Diminishing returns has set in the Indian tax system for the lack of necessary organization to bring rising national income and taxation into some reasonable realtionship. The ratio of tax revenue to income remained the same despite the increase in the marginal rate of taxation. Borrowing programmes are satisfactory only to a certain extent and the proportion of public debt to national income is still very low. It constituted less than 20 % of the national income in 1960-61 whereas in the developed countries the percentage varied between 200 to 300. Consequently, a greater pressure has been exerted on the demand for loans from abroad and deficit financing at home, both of which, if carried beyond certain limits, contradict the requirements of the"take-off Stage".

Monetary Problems and Policy

A few developments during the last year of the previous Plan need to be mentioned here even at the cost of repetition. Being the last year of the Plan development expenditure was stepped-up in order to reach the planned targets, creating an over-all budgetary deficit of Rs. 180 crores, which was nearly double the amount the year before. This combined with other factors led to an increase in the money supply to the order of Rs. 264 crores in 1955-56 as against Rs. 133 crores in 1954-55 and an over-all decline of Rs. 198 crores in 1951-54. [22] Against this background of a rapid increase in the money supply agricul-

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[22] See Table 26

tural production declined from the record level reached in 1954-55, owing mainly to the fall in the output of foodgrains and industrial production remained more or less stagnant. The index of wholesale prices rose by 15 % during the last nine months of 1955-56 and that of the foodgrains by 30 %. As the prices were depressed for the last three years, a rise was not looked upon with disfavour by the authorities and they did not consider the consequences of such a rise if it went unchecked since the control machinery was not there and could not be set-up overnight. One factor that delayed rapid money price adjustment was large imports of all sorts of goods. However, with the rising prices strains and stresses in the economy began to appear, though slowly at first. It was evident that "there was thus a considerable built-up of inflationary forces just before the Second Plan began" ; [23] and the authorities failed to gauge its intensity at that time.

The busy season of 1955-56 was unusually busy creating all round stringency in the money market. The over-all situation did not warrant such a big expansion of bank credit, i.e. Rs. 183 crores. However, the explanation lay in the rise in prices and their further expected rise following the optimism created by the large development expenditure and deficit financing. During such a period of rising prices, with similar expectations, the interest rates were bound to go up. All rates hardened and for the first time the call rate went above the rates on the commercial banks' time-deposit and gilt-edged. This narrowness or elimination of the difference between the short and long term rates reflected price expectation. The Reserve Bank, instead of guiding the market, simply acquiesced and increased its advance rate to 3¼ % under the bill market scheme in March 1956.

The budget for the first year of the Second Plan did not bear much relation to the effort needed for resource mobilization for the implementation of the Plan. Half of the development expenditure was to be covered by deficit financing and

23 Appraisal and Prospects, p. 4.

foreign assistance. Even on that assumption the Planning Commission provided for the maxinum stretching of direct and indirect taxation and suggested some new tax measures. But the budget of 1956-57 was marked by the absence of strong fiscal measures as recommended by the Commission. This was mainly due to polititial factors arising out of the election in early 1957. Not only that but market borrowings for the year were put at Rs. 100 crores in the face of a rising money supply, small tax efforts and not too bright prospect of external assistance, The rising trends in bank deposits, Government control over the State Bank of India and Life Insurance Companies [24] funds and Provident funds did not warrant a low borrowing programme. It was rather a pleasant surprise to the monetary authorities when the loan programmes proved to be a success withdrawing a large sum of money from the market (see Table 35)

The success of the loan programmes combined with large deficits in the balance of payments, mostly on private account created monetary stringencies even in the slack season of 1956-57. This was inspite of the fact that the decline in the money supply in the slack season of 1956 was below normal, i.e. less than half of the expansion of the previous busy season. The demand for bank credit was running at a high level even in the slack season, and a big part of the credit was for the import of capital goods and for industries, which were more in the nature of medium term loans than the usual short-term bank credit. The banks remained in an over-extended position, so much so that in the place of a normal fall in bank credit there occurred a small rise of Rs. 4 crores in the slack season. Subsequently, credit expanded still further in the busy season of 1956-57, with the result that the advance-deposit ratio reached a record figure of 76 %. [25]

There were other developments in 1956-57 which should be mentioned here. The first and most important of these was a substantial rise in bank credit against agricultural commo-

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24 In July 1955 the Imperial Bank of India was nationalised and came to be known as the State Bank of India. Life Insurance Cos. were nationalised in Jan. 1956

25 Report on Currency and Finance, p. 956-57.

dities, particularly rice and wheat, inspite of a fall in the production of foodgrains. This was mainly due to speculative hoarding and rising prices. The advances against rice and wheat were 127 % and 80 % higher in June 1956 than the level reached in the previous year. The general index of wholesale prices rose by 8 % within the first six months of 1956-57 and that of the food groups by 12 %, and the prices of important foodgrains, such as rice and wheat were as high as 20 % or more. [26] Second, inspite of the rising trends in company profits, the index number of variable dividend securities began to fall ; the speculative rise in commodity prices diverted funds from securities to the commodity market. All rates, short and long, went up. Third, the banks started to unload government securities in the busy season of 1956-57 by amounts much larger than they took up in the slack season. Finally, on the top of all these developments came the scramble for deposits among banks, so much so that by the end of 1956-57 some banks were offering as much as 4 % on fixed deposits. An anomalous situation was created in the money market by the fact that the same rate, i.e. 3½ to 4 % prevailed both for deposits at call and term deposits. The following table reveals the interest rate structure during the second Plan period :

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[26] Ibid, p. 108.

TABLE 30

SHORT TERM MONEY RATES : 1954-55 to 1960-61

(In percent per annum)

	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
Bank rate	3½	3½	3½ - 4	4	4	4
Reserve Bank Advance Rate	3 - 3¼	3¼ - 3½	3½ - 4	4	4	4
State Bank Hundi Rate	4½ - 5	5 - 5¼	5¼ - 5½	5¼ - 5½	5¼	5¼ - 6½
Call Money Rate (Bombay)	1¼ - 3¾	3½ - 4½	2½ - 4¾	2 - 4½	2 - 3¾	3½ - 4¼
3-Month Deposit Rate (Calcutta)	2 - 2½	2¾ - 4¾	2½ - 4½	2½ - 4	2¾ - 4	2¾ - 4
6-Month Deposit Rate (Bombay)	2¼ - 3½	2 - 4¼	2½ - 4¾	2½ - 4	2¾ - 4	2¾ - 3½
12-Month Deposit Rate (Calcutta)	2½	2 - 4	2 - 4½	2½ - 4	2½ - 4	2¾ - 3¾
Bazaar Bill Rate (Bombay)	9¾ - 10	9¾ - 11¼	9¾ - 11¼	8¼ - 10½	9 - 11½	9 - 12
Bazaar Bill Rate (Calcutta)	10 - 12	10½ - 12	9¾ - 11½	9 - 11¼	9 - 10½	9½ - 13

Source : Annual Reports on Currancy and Finance, 1955-56 and 1960-61.

The strain on the economy became more and more acute which reflected in the inflationary pressure at home and more particularly in the huge deficits in the external account leading to a large loss of foreign exchange reserves - both being the result of the high tempo of development effort in the economy. The growth of real output and voluntary savings was lagging far behind the rise in overall demand generated by consumption and investment expenditure, The Reserve Bank of India, at this stage evolved a new monetary policy which it termed as "controlled expansion".[27] It was realised that a growing economy would require continuous increase in the money supply and bank credit but as there was excess demand in the economy, reflected in the sharp and continuous rise in commodity prices since June 1955, with a noticeable increase in speculative and hoarding tendencies and also in a heavy deficit in the balance of payment position, the need for restraining monetary expansion became paramount. As there was neither price control nor rationing working in the system, heavy responsibilities were placed on the shoulders of the monetary authorities. The Reserve Bank first developed a series of qualitative credit measures as substitute for physical controls and those were applied in conjunction with the general quantitative methods of credit control with a view to regulate the cost and availability of bank credit and its volume and direction. At the same time, the Reserve Bank liberalised lending under the Bill Market Scheme.

The qualitative credit control which came to be increasingly used in other countries after the War became the main feature of the new monetary policy. The Reserve Bank of India had already legally empowered itself by the Banking Companies Act, 1949, to pursue selective credit policy. The policy officially began in September 1956 though it operated since May 1956 when directives were sent out to Banks for restricting credit against paddy and rice. The other directives were

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[27] Ibid, p. 31-32.

sent ot banks in September 1956 and in February 1957 for the first year of the Plan asking for a reduction of advances against certain commodities. On an average the Bank issued half a dozen of such directives each year during the Second Plan period.

The Reserve Bank put equal emphasis on the cost and availability of credit and its direction. The Bank's advance rate under the Bill Market Scheme was raised from 3¼ % to 3½ % in November 1956, and it became 4 % with effect from February 1957 when the stamp duty on usance bills was raised. Simultaneoulsy with a view to avoid discrimination against borrowing under the bill market scheme the Bank raised its rate from 3½ % to 4 % on advances against government securities. Subsequently, the Bank rate itself was raised to 4 % with effect from May 1951. and the effective borrowing rate of scheduled banks against usance bill became 4 1/5 % from that month owing to a further change in the stamp duty. [28]

Returning to the monetary contitions, the busy season of 1956-57 remained unusually busy and stringent. The slack season of 1957-58 was, to some extent, affected by the prolongation of the previous busy season. The year 1957-58 also experienced an accentuation of the strains and stresses to which the economy was subjected during the last two years. This was particularly so during the first half of the year during which the price situation and the balance of payments received further set-backs. However, there were several factors, monetary and non-monetary, at work, which contributed towards the comparatively easy money conditions and relative price stability from August 1957, onwards.

First, although the development expenditure and deficit financing continued to be high, i.e. Rs. 861 and Rs. 496 crores respectively in 1957-58 as against Rs. 535 and Rs. 250 crores respectively in 1956-57, the rate of increase in money supply declined. It fell from 13,7 % in 1955-56 to 5,9 % in 1956-57 and further to 3,3 % in 1957-58 (see Table 32); the

28 Ibid.

huge deficits in the balance of payments being the main counteracting factor.

Second, banks experienced an accural of deposits at a rapid rate, particularly time deposits. With increased resources banks reduced their indebtedness with the Reserve Bank and improved their liquidity position. Money market stringency which became acute in the first half of 1957 gave place to general easiness. The inter-bank call money rate which touched a peak of 3½ - 4¼ % at the beginning of the year steadily declined to 2½ % and moved around 3 % during the busy season of 1957-58. [29]

Third, a number of measures were concentrated in 1957-58 which did not allow speculative expectations to build up. There were continuous and intensified credit measures applied and improvements also on the supply side, particularly food stuffs. Increased domestic production of foodgrains in 1956-57 was further supplemented by imports from the United States under the Public Law 480 commodity assistance. The imports of agricultural commodities under the P.L. 480 agreement, which was renewed during the following years, had a profound effect not only on speculation and the price level but also on the gilt-edged market and the effectiveness of monetary policy itself. [30] The Government also took various steps such as dividing the country into several zones, opening fair price shops for the better distribution of food stuffs and placing a ban on the export of food.

Lastly, the year witnessed the biggest tax measures, including a wealth tax and expenditure tax and an intensified borrowing programme.

Prices, which were rising continuously during the first half of 1957 showed a downward tendency from August 1957;

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[29] Report on Currency and Finance, 1957-58, p.30.

[30] "Effects of the United States Commodity Assistance to India on Money Supply", The Reserve Bank of India Bulletin, January 1963 ; J.D. Sethi, op. cit, p.288-290.

the index of wholesale prices was 113 in August came down to 106 in December 1957 and remained at that level till March 1958. The rate of investment in the private sector also tended to decline somewhat, mainly on account of the drastic import cuts and partly due to uncertainty and hesitancy caused by the tax proposals. Consequently, the slack season of 1957-58 was more slack and the busy season less busy. The advance deposit ratio which reached a record level of 76 % in the previous busy season came down to 63.5 %. However, these salutory developments, to some extent, were marred by a flagging in the rate of industrial production.

In the following year 1958-59 the Indian economy revealed mixed trends, with a blend of the elements of recession and the forces of sustained progress accompanied by inflation. With continuing drastic import cuts and larger foreign assistance, the balance of payment position underwent a distinct change, with a marked easing of the drain on foreign exchange reserves (see Table 28). This improvement was, however, associated with a slowing down of the rate of new investment and of the growth of industrial production. The general price level also rose continuously ; it rose from 106 in March 1958 to 116 in October 1958, and the prices of food articles rose from 103.4 to 121.0 during the same period. This was mainly due to the sharp fall in the production of foodgrains in 1957-58, During the latter half of the year, however, the situation improved with a seasonal decline in prices, due mainly to the prospect of bumper agricultural output in 1958-59 season and partly to the recovery in the rate of industrial production.

The seasonal swings, which almost disappeared in 1957-58 asserted themselves again in 1958-59 and became more pronounced during the following years. Import restrictions removed an important and uncertain factor, i.e. expansion and contraction of money supply resulting from the balance of payment position on private account. Two factors left were development expenditure and deficit financing. The development expenditure increased from Rs. 876 crores in 1957-58 to Rs- 981

TABLE 31

SEASONAL TRENDS IN SELECTED ITEMS IN SCHEDULED BANKS ASSETS AND LIABILITIES

(in lakhs of rupees)

Seasons	Demand Liabilities	Time Liabilities	Aggregate Deposit Liabilities	Borrowing from the Reserve Bank	Cash Balances with Reserve Bank	Cash Ratio at the end of the period %	Investment in Government securities	Investment Ratio at the end of the period %	Bank credit	Credit deposit ratio at the end of the period
Slack 1955	+ 20,97	+ 37,84	+ 58,82	- 21,37	+ 12,41	9'1	+ 47,71	38'4	- 31,15	58'0
Busy 1955-56	+ 36,95	+ 5,00	+ 41,95	+ 50,35	- 6,74	8'1	- 36,93	33'4	+ 164,49	71'2
Slack 1956	- 5,17	+ 29,66	+ 24,48	+ 1,91	+ 1,02	8'0	+ 16,09	34'2	+ 3,67	70'0
Busy 1956-57	+ 86,66	+ 46,44	+ 133,11	+ 14,90	+ 16,00	8'5	- 26,96	28'2	+ 148,42	74'5
Slack 1957	+ 17,97	+ 125,06	+ 143,03	- 42,94	+ 40,22	10'5	+ 49,67	28'9	- 41,89	63'6
Busy 1957-58	+ 19,75	+ 128,81	+ 148,56	- 9,92	- 10,74	8'8	+ 50,41	29'4	+ 89'42	63'3
Slack 1958-59	- 69,59	+ 133,92	+ 64,33	- 17,59	+ 13,66	9'3	+ 174,75	39'3	- 117'91	53'2
Busy 1958-59	+ 66,22	+ 49,68	+ 115,90	+ 24,94	- 14,61	7'8	- 3,18	36'4	+ 181,70	60'3
Slack 1959	- 53,16	+ 151,63	+ 106,46	- 13,35	- 21,11	6'2	+ 178,00	44'2	- 78,95	52'3
Busy 1959-60	+ 69,75	+ 61,10	+ 130,85	+ 29,80	+ 29,67	7'3	- 52,49	39'4	+ 188,93	58'6
Slack 1960	+ 7,41	- 30,68	- 23,26	- 27,02	+ 4,17	7'6	- 52,33	36'2	- 20,31	58'2
Busy 1960-61	+ 52,63	- 43,34	+ 9,29	+ 21,53	- 23,24	6'3	- 126,32	29'4	+ 198,53	68'3

Note : the slack season is from May to October and the busy season is from November to April. The aggregate deposit liabilities and investment in Government securities reflect the changed arrangement of P.L. funds from May 1960 onwards.

Source : Report on currency and finance, 1960-61. Statement, 26-

crores in 1958-59 ; but the deficit financing was reduced due to a good collection of taxes and larger domestic borrowings. Consequently there occurred a big fall in bank credit in the slack season of 1958, cancelling the entire expansion of the previous not too busy season. However, in the busy season of 1958-59, the expansion of bank credit assumed a larger dimension, i.e. Rs. 182 crores , the impact of which to some extent assuaged by the substantial increase in bank deposits. The process, however, was intensified greatly in the next two years when the money supply began to increase and speculators' expectations also began to play their role. The following table shows the seasonal trends in selected items of the scheduled banks' assets and liabilities.

The above table also reveals an interesting aspect of the banking situation during the second Plan period. In contrast to the position in the first Plan, when both demand and time deposits increased, but slowly, the rate of expansion of bank deposits had been quite rapid in all these years of the Second Plan. This increase was almost entirely in time deposits. Banks did not appreciate the importance of this change, being under the stress of the scramble for deposits started in 1956-57, until October 1958 when they voluntarily came to decide on the limits to deposit rates. It was decided that no interest would be paid on deposits on call and on notice of less than seven days, and that the ceiling rates on time deposits for less than three months and those for three months or over were fixed at 3 1/8 % and 4 % respectively. Inter-bank borrowings were excluded from this agreement. The ceiling rates on deposits were brought down by ½ % in September 1959 and in October 1960 banks evolved an elaborate rates scheme covering various types of deposits. The ceiling rates on deposits were further revised in March 1961. [31] These inter-bank agreements on maximum deposit rates brought some degree of consistency among the different types of deposits. But some deposit rates were fixed at above the prevailing Bank rate. The need for healthy money market conditions demand that deposit rates must be lower than the Bank rate.

During the last two years of the Second Plan the development outlay was stepped up in order to reach the planned target ; it rose from Rs. 981 crores in 1958-59 to Rs. 1006 crores in 1960-61, bringing the total de Rs. 4600 crores over the entire plan period. Deficit financing remained low during these two years [32] but there was a substantial expansion of the money supply. This was primarily due to the injection of P.L. 480

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31 For details, see the Reserve Bank of India Bulletin, March 1960, p.357 and the Report on Currency and Finance, 1960-61, p.41.

32 The overal deficit of Centre and States, which was as high as Rs. 500cr. in 1957-58 declined to Rs. 169cr. in 58-59 and further to Rs.159cr and Rs.126 cr. in 59-60 respectively. Report on currency and finance, 1960-61, p. 77.

counterpart funds and a strong upsurge of the private sector's demand for credit. Money supply with the public revealed an expansion of Rs. 205 crores and Rs. 201 crores, i.e. 8.2 % and 7.5 % in 1959-60 and 1960-61 respectively as compared to 4.6 % and 3.3 % respectively during the previous years. The total expansion of the money supply during the Second Plan period was Rs. 722 crores, i.e. 33.1 % as compared to Rs. 199 crores or 10 % during the First Plan period. The money supply increased by Rs. 921 crores or by 46.6 % over the decade covering the two Plans.

TABLE 32

VARIATIONS IN MONEY SUPPLY SURING THE SECOND PLAN

(In crores of rupees)

	Out-standing as on March 30, 1951	Variations during 1951-1952 to 1955-1956	Out-standing as on March 30, 1956	1956-57	1957-58	1958-59	1959-60	1960-61	Variations during 1955-1956 to 1960-1961	Out-standing as on March 30, 1961
Currency with the public	1,329'0	166'2	1,505'2	51'8	51'3	118'0	138'7	167'1	527'0	2,026'9
Other deposits with the Reserve Bank of India	+ 26'0	- 14'0	+ 12'0	- 0'4	8'2	- 0'6	+ 2'5	- 2'9	6'8	19'0
Bank Money	620'7	46'5	667'2	77'5	17'6	- 7'4	63'6	37'3	188'6	855'8
Total Money supply with the Public	1,975'7	198'7	2,184'4	128'9	77'1	110'0	204'8	201'5	722'4	2,901'7

Source : The Reserve Bank of India Bulletin, July 1961 ; and the Report on Currency and Finance, 1960-61, P. 34.

An analysis of the seasonal trends revealed a smaller decline in bank credit. i.e. Rs. 79 crores in the slack season of 1959-60 as against an expansion of Rs. 182 crores in the previous busy season. Factors partially affecting the seasonal trends, which became more pronounced in the next slack season, was the growing pace of industrial and non-seasonal activities. The money market continued to be easy inspite of the small return of funds of banks through the control of credit ; this was mainly due to the higher rate of accrual of deposits. However, in the busy season of 1959-60 bank credit recorded an expansion of Rs. 189 crores, thus surpassing the previous year's record of Rs. 182 crores (see Table 31). The increased demand for credit was met by banks partly out of their increased resources, partly by unloading government securities and partly by increased resort of central banking accomodation. [33] The money market hardened, call money rate among larger banks reached 3½ to 4 1/8 % in April 1960.

The general price level continued to rise from March 1959 onwards till the end of the Second Plan period. This rise was partly functional and partly speculative. There were also notable changes in the composition of the general index of wholesale prices. Previously, the prices of food articles and raw materials, particularly those of the former group, were fluctuation widely and the prices of manufactures exhibited a market degree of stability. However, from March 1959 onwards the prices of raw materials, intermediate products and manufactures rose at a faster rate than the prices of foodstuffs and became the important contributory factor towards the rise in the general price level. [34] This was partly due to a decline in the output of industrial raw materials, especially fibres, in the face of rising demand. But perhaps what was more important was that inflationary forces started to permeate through the economy as a whole.

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33 Regarding banks' unloading of securities in the busy season of 1959-60 see Table 30. Scheduled banks' outstanding borrowings from the Reserve Bank at the end of April 1960 stood at Rs.44cr. as compared to Rs.14cr. at the beginning of the busy season. Report on Currency and Finance, 1959-60, p.32.

34 Ibid, p.21.

Over the Second Plan period, the general index of wholesale prices recorded a rise of 30 % as compared to a decline of 13 % during the First Plan. The prices of food articles and the cost of living index increased by 24 % between 1956-57 to 1960-61 ; the prices of manufactures increased by 26 % and those of the raw materials by 48 % during the same period. Thus, although the prices continued to fluctuate widely during the Second Plan period, the over-all situation had been less explosive or alternatively less depressive than that witnessed since 1947-55.

TABLE 33

INDEX NUMBER OF WHOLESALE PRICES - BY GROUPS

Revised Series, base year 1952-53=100

End of	General Index	Food Articles	Raw Materials	Intermediate Products	Manufacturers	Cost of living India : all India 1949 = 100
October 1955	90'6	85'1	94'7	96'9	98'7	96
March 1956	98'1	92'9	109'4	110'5	101'6	100
December 1956	107'9	104'8	119'4	113'9	107'8	109
March 1957	105'5	102'3	117'2	108'9	105'8	107
August 1957	112'9	112'1	120'1	108'2	108'6	113
December 1957	106'3	102'9	114'8	105'6	107'7	113
March 1958	106'1	103'4	112'9	107'1	107'4	110
October 1958	116'0	121'0	116'8	109'3	108'4	123
March 1959	112'7	112'7	115'9	109'0	109'5	117
July 1959	116'9	121'1	120'5	108'8	109'2	124
December 1959	117'6	116'7	129'2	118'6	113'5	122
March 1960	118'6	116'5	132'0	121'3	116'0	121
June 1960	122'9	120'3	138'8	129'0	118'7	124
October 1960	126'4	121'6	146'9	130'8	124'3	125
March 1961	127'5	118'1	158'5	137'3	127'4	124

Source : Compiled from the Reserve Bank of India, Monthly Bulletins.

The rising trends in prices, the rapid expansion of bank credit, the unhealthy boom in the stock and capital markets and speculative activities in the commodity markets - all these re-emphasised the need for monetary restraint. In recent years, the Reserve Bank's policy had been one of "controlled expansion" ; but as the latent forces of inflation started to manifest themselves the Bank put more emphasis on monetary control. There was also recognition of a shift in the character of the prevailing inflationary situation, i.e. the upswing in prices since the beginning of 1959-60 had occurred, unlike earlier years, in the wake of an all round increase in production. [35] It appeared that the major inflationary factor was rather the high level of aggregate monetary demand by way of investment and consumption expenditure, which therefore needed to be curbed.

The Reserve Bank pursued a restrictive credit policy with great vigour during the last two years of the Plan ; it applied all the available tools in its armoury, which came as the climax of its twenty-five years' existence. The Reserve Bank extended the scope of selective credit measures to such an extent that those tended to be less selective and more general in nature. Towards the end of 1959-60 those were further reinforced by the instrument of general credit restraint, namely, variable reserve requirements. Scheduled banks were required to maintain with the Reserve Bank additional balances [36] equal to 25 % of the increase in total liabilities since March 11, 1960. The additional reserve ratio was raised to 50 % in May

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35 Indices of agricultural and industrial productions were :

	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
Agricultural production (1949-50=100)	116.8	124.3	115.3	133.8	128.5	139.9

	1955	1956	1957	1958	1959	1960	1961
Industrial production (1951=100)	122.2	132.6	137.3	139.7	152.7	169.9	180.9

Source : The Reserve Bank of India Bulletin, Aug.1962

36 All scheduled banks were required, under the Reserve Bank of India Act, 1934, to maintain with the Reserve Bank a balance of not less than 5 % of their demand liabilities and 2 % of their time liabilities, This provision of fixed reserve ratio was amended in 1956 whereby the Reserve Bank could vary those ratios and also ask for supplementary reserves in increase in deposits.

1960 with a view to ensure satisfactory reduction in credit in the slack season, especially in view of the larger expansion in the preceding busy season.

The additional reserve requirements had a marked effect on the liquidity position of scheduled banks, and stringent conditions prevailed in the money market even in the slack season of 1960-61 ; but their effect on bank credit was negligible. The contraction of credit in the slack season was markedly low, i.e. Rs. 20 crores, the reduction in seasonal advances was largely offset by an increase in non-seasonal advances. [37] The high level of bank credit in the slack season was facilitated by large borrowings from the Reserve Bank and by the liquidation of investment in government securities. In order to check this unlimited resort to central banking accomodation the Reserve Bank announced on September 21, 1960, its decision to introduce with effect from October 1, a system of graded lending rates keeping the Bank rate stable at 4 % and fixing a ceiling on central banking accommodation. Banks had to pay a penalty rate for any borrowings beyond the quota limits. However, with the advent of the busy season and the emergence of acute stringency in the money market, the Bank gradually withdrew the additional reserve requirements. But graded lending rates and the quota system continued to be important features of the Reserve Bank's monetary policy. In the following section we shall examine the efficay of various instruments of monetary policy as applied by the Reserve Bank during the Second Plan period.

OPERATIONS OF THE RESERVE BANK OF INDIA : 1956-57 to 1960-61

During the First Plan period we have witnessed monetary contraction and expansion in the most crude from unrelated to the twin problems of stability and growth. In this respect the Reserve Bank's policy of "controlled expansion" during the

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[37] Report on Currency and Finance, 1960-61, p. 42.

Second Plan period was a far more realistic approach and better suited to the needs of a developing economy. It was realised that a rapidly growing economy would require a continuous increase in the money supply and bank credit ; but as there already existed excess demand and speculative tendencies in the economy, the need for restraining monetary expansion became paramount. The credit policy of the Reserve Bank during 1956-57 to 1960-61 was governed by the twin considerations of assisting an expanding economy and restraining inflationary pressures.

In pursuance of its policy of controlled expansion the Reserve Bank made use of general quantitative as well as qualitative instruments of credit control. The Bank put equal emphasis on the cost and availability of credit, and its direction through selective measures. At the same time, the Bank made increased provision for central banking accomodation through the liberalization of credit under the Bill Market Scheme, and through relaxation in its open market operations, for the Bank started making discriminating purchases of securities. However, as the inflationary forces gathered momentum during the last three years of the Plan the Reserve Bank re-emphasised the need for monetary restraint and control of credit. It had increased lending rates earlier and put constant pressure on the sale of securities in the open market. The Bank also extended its net-work of selective credit control measures with a view to directing credit to the desired channels or to prevent its misdirection in the form of advances against commodity hoarding and speculation. Towards the end these credit measures were supplemented by a direct quantitative method of control, viz. the variable reserve ratio, which was further buttressed by a system of graded lending rates keeping the Bank rate at 4 % and by the introduction of ceilings in central banking accommodation and supplementary quotas at a penal rate.

Thus, towards the end of the Second Plan period we find that the Reserve Bank has emerged from its isolation and has acquired a degree of maturity where the Bank is operating an integrated credit policy and applying various instruments

of credit control in varying degrees of emphasis in pursuance of its policy of controlled expansion. This, however, does not mean that the success of the monetary policy during the Second Plan period was entirely due to the Reserve Bank's credit policy or that the Bank did not make any mistakes. But it contained bold new experiments, for which the Reserve Bank should be credited. In the following pages we shall examine the efficacy of the various credit instruments as applied during the Second Plan period.

LOANS AND DISCOUNT OPERATIONS OF THE RESERVE BANK : The Failure of the Bill Market Scheme.

The reserve Bank's loans and discount policy continued to be governed by the policy announced in November 1951, i.e. it would grant advances against government securities and against bill under the Bill Market Scheme, under Sections 17 (4) (a) and 17 (4) (c) respectively of the Reserve Bank of India Act. The Bill Market Scheme was gradually extended to cover all scheduled banks, irrespective of their size of deposits and the Reserve Bank also reduced the minimum amount of each individual bill and the minimum amount of each loan from the central bank.[38] The Scheme was further extended in 1957 to cover export bills. After a modest beginning, advances under the Scheme were as high as 53 % and 48 % of gross advances made by the Reserve Bank in 1955 and 1956. But the Bill Market Scheme met near failure since 1957 for several reasons and scheduled banks reverted to their old practice of borrowing against government securities.

The success of the Bill Market Scheme before 1956 may be attributed to

1) the acute monetary stringency caused by the refusal of the Reserve Bank to purchase government securities on a large scale from banks as in the years before November 1951 ;

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[38] Supra, p. 158.

2) the incentive provided to banks to convert a part of the cash-credits and overdrafts into loans against usance bills on account of the assurance given by the Reserve Bank that it would advance loans against usance bills at a concession rate of interest.

The Scheme was working successfully as a seasonal affair under these two conditions. It did not move beyond a bilateral arrangement between the Reserve Bank and banks to meet seasonal demand for funds. No effort was directed towards the creation of a bill market in the sense and form in which it exists in London, nor towards making it an integrate part of the short-term money market. No steps, for example, were taken to create such familiar constituents or their alternatives to suit Indian contitions - as Discount Houses, Acceptance Houses, Market Syndicates, Bill brokers other than Government broker, etc. - which form the backbone of the London money market. Again the Bill Market Scheme was confined to the organised sector of the Indian money market and the Reserve Bank did not attempt to forge some links through which the present hundi business, the nucleus of the real bill market in India, could be brought within the scope of the Bill Market Scheme and thereby stronger connections could be established between the two sectors of the Indian money market. [39]

The Reserve Bank started purchasing securities in the open market from 1955-56 onwards and the concession rate of lending under the Scheme was withdrawn in November k956. Not only that but from May 1957 the effective borrowing rate of scheduled banks against usance bill became 1/5 % higher than the Bank rate owing to a change in the stamp duty. [40] Consequently, banks started to meet the seasonal demand for funds either by borrowing against government securities of by selling those in the open market and borrowing under the Scheme

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39 The Central Banking Enquiry Committee recommended the creation to a bill market with this particular point in mind, so that a bill of exchange drawn in one sector of the market could be discounted in the other and thus funds would flow freely from one sector to the other. The Report, 1931. pp. 401-402.

40 Supra, p. 184

gradually reduced to a small amount as it will be evident from the following table.

TABLE 34

GROSS ADVANCES (i.e. EXCLUSIVE OF REPAYMENTS)

MADE BY THE RESERVE BANK OF INDIA

(In crores of rupees)

Last Friday of	Under Section 17(4)(a) (against Government securities)		Under Section 17(4)(c) (against bi ls under the Scheme)		Total Advances
1955	199.94	(47.06)	225.44	(52.94)	425.38
1956	466.95	(51.66)	436.82	(48.84)	903.77
1957	353.78	(46.10)	414.81	(53.90)	768.59
1958	237.57	(60.80)	153.06	(39.20)	390.63
1959	518.20	(86.10)	83.32	(13.90)	601.52
1960	502.85	(85.40)	85.41	(14.60)	587.47

Figures in brackets indicate percentage of total advances.

Source : Annual Reports on Trends and Progress in Banking in India.

During the last two years of the Second Plan scheduled banks' borrowings, especially against government securities increased condiderably and such borrowings were not confined to the busy season only. In the slack seasons of 1958, 1959 and 1960 the contraction of bank credit was small and partially offset by non-seasonal advances. [41] In view of the growing inflationary pressure, speculative tendencies, rising prices and high level of bank credit, the Reserv e Bank, for the first time, considered it necessary to apply the instrument of variable reserve requirements in the slack season of 1960. The supplementary reserve ratios had a marked effect on the liquidity position of scheduled banks, but their effect on bank credit in the slack season of 1960 was negligible. The high level of credit in the slack season was party financed by increased borrowing from the Reserve Bank. Thus, changes in the scheduled banks' reserve position brought about by the additional reserve requirements were, to some extent, offset so readily by changes in borrowings from

41 See Table 31.

the central bank through discounts and advances so as to leave the availability of credit from the commercial banks largely unaffected. In order to check unlimited recourse to central banking accommodation the Reserve Bank announced in September 1960 its decision to introduce with effect from October 1, a system of graded lending rates and ceilings on central banking accommodation.

Specific ceilings on commercial banks' borrowing from the Central Bank have become increasingly common in the post-war period. [42] The main features of the new system were that each scheduled bank was assigned in respect of borrowing from the Reserve Bank, a quota for each quarter equal to half or the average amount of statutory reserves required to be maintained by it under Section 42 (1) of the Reserve Bank of India Act during each week of the previous quarter. Borrowings within the quota limit were to be charged interest at the Bank rate, i.e. 4 %. Any borrowing over this limit upto 200 % of the basic quota would bear a penal rate of 1 % over the Bank rate ; any borrowing beyond this limit would bear a penal rate of 2 % over the Bank rate. [43]

The system of quotas and graded lending rates, keeping the Bank rate stable, is particularly suitable for an underdeveloped country like India, where the Government had embarked upon large scale borrowing to finance development project. It is to the interest of the authorities to keep interest rate

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[42] P.G. Fousek, Foreign Central Banking : The instruments of Monetary Policy, 1957, p.19. Also refer to my own article entitled "Operation of the Ceiling Techniques in Credit Policy in the Post-War Period", Journal of Indian Institute of Bankers, January 1961.

[43] The Report on Currency and Finance, 1960-61, P.42. Since the rates applied to borrowings under sub-sections 4(a) and 4 (c) of Section 17 of the Reserve Bank of India Act, it was considered no longer necessary to fix separate ceilings for individual bank for borrowings under the Bill Market Scheme.

charges on public debt as low as possible and to prevent "demoralization" of the capital market. At the same time, it provides scope to the Reserve Bank to manoeuver with the cost and availability of credit. The efficacy of such credit measures was demonstrated by the fact that between September 30, and November 25, 1960 bank credit declined by Rs. 29 crores in contrast to a rise of Rs. 3 crores in the corresponding period of the previous year. [44]

MARKET BORROWINGS DURING THE SECOND PLAN AND OPEN MARKET OPERATIONS

It was noticed in the previous chapter and in this chapter how the Reserve Bank increased its hold on the money market and came to make increasing use of debt management was reoriented to meet, on the one hand, the greatly increased requirements of development expenditure, and, on the other, the changing conditions of the market. At the beginning of the Second Plan, the gilt-edged market had become such as to absorb substantial loan issues without much strain. The capacity of the market was further enhanced by the nationalization of the Imperial Bank of India and Life Insurance companies, and by the growth of providend fund institutions -- all these augured well for large public borrowing necessitated by large scale planned investment.

Inspite of the changed circumstances the planners erred on the side of undue moderation and underestimated the strength and capacity of market. The Planning Commission provided, on the advice of the Reserve Bank, total gross borrowings of Rs. 1130 crores [45] and net borrowing of Rs. 700 cr. over five years, against a planned deficit of Rs. 1200 crores. Of course, the experience of the First Plan borrowing programme was disappointing but, as discussed in the previous chapter, the Reserve Bank's monetary policy was the main cause of this disappointment. In contrast to that fo the First Plan, the borrowing programme of the Second Plan appeared substantial, but in relation to the planned expenditure and deficit financing and the

44 Ibid, p. 43. It is also to be remembered that this contraction of credit took place at the beginning of the busy season.

45 The Second Five-Year Plan, p.80.

need for resource mobilization in the Plan, it was very modest indeed. It was no wonder that without any extraordinary effort, the total net borrowing overreached the target. If the sale of Treasury Bills - both "tap" and "tender" - were taken into account, the total borrowing would be double the planned target. The following table shows the market borrowings of the Centre and the States during the Second Plan period.

TABLE 35

MARKET BORROWINGS OF THE CENTRE AND STATES, 1956-57 to 1960-61.

(In crores of rupees)

Y E A R	Amount of Issue	Cash Receipts	Conversions	Total Subscription	Repayment of maturing loans	Net borrowings in Cash
Central Governments :						
1956 - 57	150 (100) *	77	81	158	--	77
1957 - 58	130 (100) *	91	45	136	25	66
1958 - 59	195 (145) *	193	9	202	12	181
1959 - 60	225 (225) *	139	90	229	24	115 a
1960 - 61	175 (225) *	106	75	181	39	67 + 10 b
State Governments :						
1956 - 57	64	66	2	68	3	63
1957 - 58	9	9	1	10	4	5
1958 - 59	50	49	5	54	3	46 + 16 c
1959 - 60	63'5	68	1	69	1	67
1960 - 61	75	74	6	80	7	67

Total Net Borrowings : Rs 780 cr.

Note: *)Figures in brackets relate to the borrowings provided in the budget.
a) Including the Second Tranche. b) Receipts from Prize Blnds. c) Net effect of issue and repayments of State Governments Special Bonds

Source : Annual Reports on Currency and Finance, 1956-57 to 1960-61, Section on Public Debt.

There were some important changes in the issue of loans during the Second Plan period. The first and foremost of these was that the Reserve Bank put great emphasis on the sale of medium and long-term securities. As the Plan progressed the whole borrowing pattern marked a turn away from the dominence of short and medium term loans of the period ever since independence to medium and long term loans. So much so that a shortage of short-term securities was felt by banks, which still preferred short-term securities inspite of the changed circumstances. Scheduled banks experienced an unprecedented increase in deposits - mainly on the side of time deposits - yet they were unwilling to invest in long-term securities. The Reserve Bank, however, did not yield, and followed the right course consistent with the requirements of long-term planning. The Bank also began to cater more to the needs of other institutional invertors than those of banks. These policies, in a way, forced scheduled banks to abandon the policy of "wait and see" and to conform to the pattern in which long-term securities had a predominent place.

For the first time switching between short and long securities was used as an instrument of monetary policy by the Reserve Bank, thus imparting greater flexibility to the entire debt management policy and creating healthy preferences among banks. Besides, tap sales by the Bank became one of the most successful operations. This was made possible by the withdrawal of ad hoc Treasury Bills from the Reserve Bank. [46] Most of the State loans issued during this period were of medium term. Only two or three years before it did not seem possible that State loans could be a success or long-term securities could be sold in any amount.

The most important factor behind the success of debt management was the P.L. 480 counter-part funds. Funds realised from the sale of imports were kept in the State Bank of India

46 In 1959-60 Rs. 450 crores of outstanding Treasury Bills were converted into long-term loans and sold either through tap or taken up directly by the Reserve Bank. Another Rs. 50 crores of outstanding Treasury Bills were converted into medium term loans in 1960-61.

as time deposit and could be utilized only for investment in government securities. The State Bank of India began to subscribe in a big way to the Government's borrowing programme. This not only helped to revise the maturity pattern of marketable securities, but also had a favourable effect on the prices of long-term securities, which had been sagging for a long-time and thus affecting the general pattern of interest rates.

The impact of the P.L. counterpart funds on the gilt-edged market was increasingly felt from the middle of 1957. But before that the market had a serious set-back in the busy season of 1956-57. The explanation behind this set-back, according to the Reserve Bank, lay in the unusual demand for funds in the busy season of 1956 and very high short-term rates. But apart from the acute seasonal stringency leading to the unloading of securities by banks, the main reason lay in the interest policy of the Reserve Bank. In the busy season of 1956-57 the Bank was engaged, in one form or another, in raising rates [47] and created highly confused and uncertain conditions in the market. However, the uncertainty of rates was removed when the Bank rate itself was raised to 4 % in May 1957. From that time onwards the monetary situation changed radically. Banks went on continuously increasing their volume of government securities year after year. Their resources had grown tremendously while credit restrictions were vigorously imposed. Banks had no other choice but to buy securities. The Reserve Bank was able to improve from 1957 onwards, the prices of securities sold on tap and their yield brought to a level less than the bank rate.

These improved conditions eliminated any need of big open market operations in support of gilt-edged (except for the usual support needed at the time of loan issue), and not only that but from 1957 onwards, the Reserve Bank began a new phase of net sales of securities from its own investment account and Central Government's Cash Balance Investment Account. The fol-

47 Report on Currency and Finance, 1956-57, p. 37-32.

lowing table shows the extent of open market operations of the Reserve Bank during the Second Plan period.

TABLE 36

OPEN MARKET OPERATIONS IN CENTRAL GOVERNMENT SECURITIES BY THE RESERVE BANK OF INDIA

Year	Open market purchases (-) from/Sales (+) to the public from the Bank's Investment Account and Central Government's Cash Balance Investment Account.
1956 - 57	- 19.1
1957 - 58	+ 85.2
1958 - 59	+ 89.0
1959 - 60	+ 60.6
1960 - 61	- 125.1

Source : The Reserve Bank of India Bulletin, April 1962, p.507.

We have already referred to the unusually busy season of 1956-57, when the banks unloaded government securities. However, from July 1957 the picture was one of continuous and heavy net sales of securities, which amounted to Rs. 224 crores by March 1960. To a considerable extent these sales represented investments in government securities by the State Bank of the funds accruing to it on account of the operations of P.L. 480. Sales were also facilitated by the emergence of slackness in the economy consequent on the imposition of severe restrictions on credit and on imports, which created conditions of excess liquidity and a strong demand for securities, particularly from banks. The Reserve Bank took advantage of the situation and the substantial net sales were made at rising prices.

However, in the last year of the Plan net purchases amounted to Rs. 125 crores. This was mainly due to a change in the arrangements of P.L. funds from May 1960 onwards, when those funds flowed directly to the Reserve Bank which inves-

ted them in special government securities. Furthermore, part of the past accumulations of P.L. deposits with the State Bank was transferred to the Reserve Bank in monthly instalments of Rs. 12 crores each during the period July 1960 to June 1961, which involved disinvestment of securities by the State Bank of India. [48]

RESERVE REQUIREMENTS POLICY OF THE RESERVE BANK :

The commercial banks' cash reserve requirements have become an important credit control instruments in many countries since 1930's. These requirements serve, when altered, as a means of influencing the availability of funds for banks loans and investments and when unchanged, may provide a basis for the carrying-out of open market operations and other monetary measures. Because of the limitation to the open market policy that exists in many countries, the emphasis has been on the first aspect - the variability of reserve requirements. Keynes commended this method as a means to offset "the possible inadequacy of ammunition interfering, in exceptional circumstances, with the efficacy of open market operations." [49] The adoption of this practice was recommended by a number of writers as being specially necessary in an underdeveloped money market. It was designated as a substitute for a rising Bank rate, and a substitute for the process of reducing bankers' deposits through sales in the open market. [50]

In India, under the original Reserve Bank of India Act, 1934, scheduled banks were required to maintain with the Reserve Bank, free of interest at all times, a cash reserve of not less than 5 % of the demand liabilities and 2 % of the time liabilities. These ratios were fixed and not subject to varia-

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48 The Reserve Bank of India Bulletin, March 1960 & March 1961.

49 Treatise on Money, Vol. II, p. 260-61 and 277.

50 For example, Sir Theodor Gregory, Evidence before the Royal Commission on Banking and Currency in Canada, Vol. VI p.3025. Prof. Sayers, Modern Banking, p.288-9. S.N. Sen, Central Banking in Underdeveloped Money Markets, p.94-95.

tions by the Reserve Bank. The policy of fixed minimum ratios in India, as in other countries, proved to be ineffective as an instrument of monetary oontrol. [51] The Indian joint-stock banks -both scheduled and non-scheduled - maintained a fairly high and fluctuation cash ratios. Such a satisfactory cash-position enabled the member banks to be independent of the central banking control so much so that they could always afford to maintain with the Reserve Bank a sum far in excess of the statutory requirements. [52] Such high cash ratios, besides being outside the control by the fixed minimum reserve requirements, always created difficulties in the execution of an open market policy of the Reserve Bank.

With a view to fit in a regulatory "level" in the armoury of the Reserve Bank to control and regulate bank credit in the country, the Bank was empowered in 1956 to vary the reserve ratios. [53] Such a reform was necessitated in view of the huge amount of deficit financing envisaged in the Second Plan. It was feared that a substantial part of the newly created money through deficit financing would find its way to the banking sector and would enhance credit-creating capacity of scheduled banks in the form of loans, advances an overdrafts, as well as bills discounted and purchases. It was the duty of the Reserve Bank to see that the banks used their resources in a manner that would not add to the inflationary forces generated by deficit financing. The provision of the variable reserve requirements endows the Reserve Bank with greater power to deal with credit-creating capacity of banks consequent upon large dose of deficit financing.

To achieve the aforesaid objective, the Reserve Bank has been empowered to vary the reserve requirements of scheduled banks, within the range of 5 % to 20 % in respect of

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[52] See Tables 9, 13 and 20.

[53] The Reserve Bank of India (Amendment Act) 1956.

demand liabilities and 2 % to 8 % in respect of time liabilities, [54] and to require them to maintain additional reserves in respect of any increase in deposit with them after a specified date and the additional reserve required to be maintained may be upto 100 % of such increases. [55] The over-all reserves to be maintained should not, however, exceed 20 % and 8 % of the demand and time liabilities respectively. There is also provision for the payment of interest at the discretion of the Reserve Bank.

We have already discussed the circumstances which led the Reserve Bank to apply variable reserve requirements for the first time. During the last two years of the Second Plan there were strong inflationary pressures and the prices were rising continuously. The Reserve Bank took a series of measures to curb the high level of aggregate monetary demand in the economy, to restraint the volume of bank credit and to reduce the liquidity in the banking system. One of these measures was the impounding of additional deposits equal to 25 % of the increase in total liabilities since March 11. 1960. With the advent of the slack season, a tightening of the variable reserve requirements was considered desirable so as to endure satisfactory reduction in credit in the context of the large expansion in the preceding busy season. Accordingly, the Bank raised the quantum of additional reserves from 25 % to 50 % of the deposits, effective May 6, 1960. [56] The Reserve Bank decided to pay interest on these additional reserves at the same rate as the average rate of interest paid by the scheduled banks on thier total deposits for the corresponding quarter but not exceeding the Bank rate.

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55 The reserve ratios are applicable uniformly to all scheduled banks. It would increase the flexibility and enhance the effectiveness of variable reserve ratios if the banks in India, following the practice of developed countries like the U.S.A. West Germany, Switzerland, Japan, etc. are classified in groups according to the capital structure, deposit liabilities or on the basis of volume of business or geographical regions.

56 In order to avoid harsh effects on scheduled banks, this impounding of reserves should be gradual or preceded by advance notice as practised in some countries.

The additional reserve requirements had a marked impact on the liquidity position of scheduled banks, but their effect on bank credit in the slack season of 1960 was negligible. It has been noted elswhere that the high level of bank credit was facilitated by larger borrowings from the Reserve Bank and by the liquidation of investment in government securities, and thereby, partially offset the restraining influence of the additional reserve requirements, However, the scheduled bank credit showed some decline after the introduction of a system of graded lending rates and imposition of ceilings on central banking accommodation in September 1960. With the advent of the busy season and the emergence of acute stringency in the money market the Reserve Bank, in conformity with its policy of operating credit regulations in a flexible manner, withdrew the directives regarding the maintenance of additional reserves in two stages. From January 13, 1961, scheduled banks were required to maintain with the Reserve Bank only the normal ratios i.e. 5 % and 2 % of their demand and time liabilities respectively. The foregoing analysis revealed that the instrument variable reserve ratios had "a somewhat limited effect". This was admitted by the Reserve Bank but added that "nevertheless it was essential." [57]

SELECTIVE CREDIT MEASURES OF THE RESERVE BANK :

In addition to the quantitative methods of credit control, which exert their influence on the whole economy in a general manner, the central banks have evolved a wide range of monetary devices to affect specific economic activities or financial operations directly. These qualitative or selective instruments of monetary control either aim at curbing credit for nonessential or speculative purposes or intend to influence the direction of credit in order to channel economic resources into desired uses, since existing financial facilities are not con-

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[58] Cited by G.P.Gupta, the Reserve Bank of India and Monetary Management, p. 193.

sidered adequate by themselves to do this. Selective credit controls assumed a great variety of forms and were employed by a large number of countries immediately after the War, but in the developed countries there has been a shift away from these controls in recent years.

However, the methods of selective credit control are now regarded to be of special significance to the underdeveloped countries.[58] As the money markets of these countries are generally underdeveloped, quantitative control operations, like changes in the Bank rate, etc. are considered to be ineffective. Even if these can be made effective, their uses may not be practicable, especially in those countries where the governments have embarket upon development loans involving large-scale market borrowings. As it is not possible in these countries to restrain the growth of public investment expenditure, there is every likelihood of the appearance of bottlenecks in particular lines of production, and of the growth of inflationary pressures in the economy. During such periods bank credit may be utilized to an increasing extent to hoard essential commodities in short supply, thereby accentuating their price-rise. It may become nesessary to restrict the use of bank credit to finance speculative hoarding of commodities without putting any pressure on other uses of bank credit. In an underdeveloped economy, it is theinvestment outlay in the trading sector that is very sensitive to the impact of speculative demand. Selective credit control measures should be utilized to restrain those types of bank lending that have the greater inflationary impact without affecting other sectors.

The Reserve Bank of India had been empowered by the Banking Companies' Act, 1949, to pursue methods of selective credit control. However, it was only from 1956 onwards that these controls took a specific form and became a part of the

58 I.G.Patel, Selective Credit Control in Underdeveloped Economies IMF Staff Papers, Sept. 1954. Ervin Miller, Monetary policy in a changing World, quarterly Journal of Economics, Feb 1956. S.K. Basu, Contemporary Banking Trends, 1957, p.186 and S.M.Sen, Op. cit, p.192.

new monetary policy. The Bank issued, on an average,about half a dozen directives each year during the Second Plan period. The most important feature of the selective credit controls was that those were directed mainly against the speculative hoarding of foodgrains through the rising margin requirements. Another variation of these controls related to putting limits on the aggregate level of advances against specified commodities, in addition to the system of margins used as a regulatory measure. In addition to the directives for a cautious lending policy banks were asked to reduce their systematic and continued dependence on the Reserve Bank for accommodation. A special feature of the qualitative control was that of prescribing limits on credit creation in the slack season so that banks should be able to start their busy season without panic and undue stringency. These credit control measures were supported by "moral suasion" through various conferences which the Reserve Bank held with other banks. Finally, these selective credit control measures were used to supplement and not to supplant the quantitative methods of credit control and the Reserve Bank employed these methods simultaneously to check inflationary pressures.

Selective credit control measures, even when buttressed by general credit restraint, encounter many serious limitations. In the first place, selective screening of loans has often proved disappointing because the end-use of bank credit that is encouraged or permitted cannot be easily controlled. An even more important limitation is the ability of the borrowers to use their own funds for nonessential or speculative purpose while requesting credit for essential outlays. Moreover, selective screening has often proved ineffective in the face of the seemingly irrefutable justification that can always be discovered for each loan, even when the resulting aggregate demand will be in excess of the country's physical capabilities. Selective controls also give rise to difficult administrative problems. These and other weaknesses assume greater proportion in underdeveloped countries, which are not only administratively backward but "are also cha-

racterised by under-developed law-abiding habits." [59]

Working of the selective credit measures in India during the Second Plan period revealed that they had limited efficacy and presented great administrative problems both for the Reserve Bank and also for the Scheduled banks. On few occasions banks had not carried out the request of directive of the Reserve Bank to bring down their advances to the prescribed limit. Even in those cases where there was some compliance with the provisions of the Directives, this generally occurred with a considerable time-lag. There is also some evidence that borrowers were able to evade the terms of the directive by borrowing from the banks on some other accounts : as for example, on several occasions while bank advances against foodgrains declined, those against others showed an abnormal rise during the same period and funds thus obtained were switched over to commodity hoarding. A sprawling network of branches presented great administrative problems and nominal compliance with the provisions of the directives had in many cases been found to conceal indirect evasions. Other selective credit measures, also indicated some of the avove mentioned defects. As for example, in the slack season of 1959 the Reserve Bank issued a directive calling for a reduction of Rs. 100 crores in credit. A reduction of bank credit to the stated amount was achieved by end-September 1959 but there was an unusual spurt in advances during October with the result that, for the slack season as a whole bank credit showed a reduction of Rs. 79 crores. [60] Similarly, inspite of the directive, scheduled banks' continued reliance on the Reserve Bank did not diminish until the Reserve Bank imposed rediscounting quotas in September 1960. There would have been much better compliance with the directives if the Reserve Bank, instead of following a policy of "moral suasion", notified the banks that the offending banks would be penalised or would not be given rediscounting facilities.

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59 S.N. Sen, Op. Cit, p. 210.

60 Report on Currency and Finance, 1959, P. 32.

However, all these criticisms do not mean that selective credit measures were complete failure in India. Selective credit measures of the Reserve Bank, in general, had a limited objective, i.e. to curb bank credit for speculative withholding of stocks of foodgrains in a period of continuous inflationary pressure. It should be remembered that in this respect the key position is held not by scheduled banks but by the vast number of indigenous bankers and merchant-cum-money lenders , and any control of scheduled banks' credit against commodity hoarding has limited effect on the economy as a whole. However, the selective credit measures presented additional bank credit which might have led to the withholding of marginal supplies from the market. By bringing about a reduction in bank advances against foodgrains, selective credit controls forced the marginal supply back to the market and so helped to prevent a further rise in food prices or even to bring down food prices. In many cases, non-availibility of credit had forced the dealess in the important urban centres to unload their stocks in the market and prices often depended on the small amount of surplus coming to the market and this also checked speculative expectation of rising prices. In this way, selectivd credit measures influenced food prices to a larger extent than was expected from their workings. The efficacy of selective credit controls in India should be judged from this point of view, i.e. not from their actual operations but from the ultimate results. However, regarding the former, these tended to be more effective as the Reserve Bank gathered experience with the method of selective credit measures, especially when the Bank imposed strong quantitative controls.

CHAPTER VIII

SUMMARY AND CONCLUSIONS

It has been noted throughout the preceding pages how the Reserve Bank of India emerged from a position of weakness and isolation and came to make increasing use of its monetary policy and established its authority over the money market. During the first ten years of its existence the Bank remained as a non-entity in the market, and the central banking regulation of money and credit was insignificant in India. The Reserve Bank's policy was one of slow drift with the course of events, instead of following a clearly defined monetary policy or giving the necessary lead to the money market, However, distinct and notable changes appeared in the constitution, attitude and activities of the Reserve Bank following the independence of the country on August 15, 1947, which established undisputed leadership of the Reserve Bank over the Indian money market.

The Reserve Bank was inaugurated in April 1935, when the whole world was emerging from an unprecedented slump. Being a primary producing country, India suffered badly during the years of depression. The situation, as we have seen, was further aggravated by the contractionist policy which the Government pursued through the foreign exchange market. [1] The Reserve Bank was established in such rigorous atmosphere of monetary deflation and consequently, failed to inspire confidence in the market. Being new, the Bank had neither resources nor adequate power to affect the monetary and credit conditions in the country and it was completely under the control of the Trea-

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[1] Supra, p. 78

sury. The banking crisis of 1938 undermined the very base of monetary management by revealing the indifference of the Reserve Bank. [2]

With the outbreak of the Second World War in September 1939 monetary management in India, as in other belligerent countries, came to be dominated by the exigencies of war finance. The direct effect of the war was to reduce the monetary regulation of the Reserve Bank to a mere routine for making available the necessary supply of money to meet the deficits of the government and Allied Powers' expenditures in India. The authorities did not put much emphasis on monetray policy to control war time inflation. After considerable delay the Government adopted a cheap money policy, but it soon degenerated into a simple mechanism of currency inflation, and the very method of war finance cut at the root of monetary policy as an anti-inflationary measure. [3] However, the Reserve Bank successfully piloted war-loans at cheapest possible rates. But such loan operations were inadequate in view of the magnitude of the problem. The excess liquidity of the banking system made it more independent of the central banking authorities and the Reserve Bank's control over the Indian money market was far from secure.

The post-war period, particularly the post-independence years, constitutes as well in the history of the Reserve Bank, as to its monetary and credit management, a period of transition to a new pattern which differed in many respect from those during and before the war. The attainment of political independence meant a change in the attitude of the Government towards economic activities from that of laissez faire to great concern and active participation, which found expression in the successive five-year plans beginning from April 1951. The character and complexion of the Reserve Bank

2 Supra, p. 100
3 Supra, p.p. 81 and 97.

changed considerably to play suitable roles in the planned economy of independent India. First, the Reserve Bank was nationalised with effect from January 1949, which removed the long-felt inadequacy of ammunition by granting wide powers of monetary control to the Reserve Bank. [4] Third, slowly but surely, the Bank came to realise the development role of a central bank in an underdeveloped country like India. Questions like the creation of a bill market, making suitable provisions for industrial finance and the reorganisation of the agricultural credit system, were discussed in various reports of the Bank and positive steps were taken in these directions with the commencement of planning. Last but not least, something like a monetary policy began to emerge after years of uncertain drifts, [5] and the Reserve Bank established its leadership over the Indian money market and the banks came to rely on the central bank to an increasing extent for accomodation.

During the post-war period the Reserve Bank of India was caught in a dilemma, not unlike that of the Federal Reserve System, i.e. either to reduce the liquidity in the system by open market sales of securuties, which would have depressed the gilt-edged market and increased the rate of interest or to maintain the stability of the gilt-edged market by purchasing securities unloaded in the market and thereby increase the liquidity in the economy. Between these two conflicting objectives the Reserve Bank chose the later alternative and adopted a policy of consolidation of the cheap money policy. During this period, owing to the decontrol measures, prices rose sharply, causing a great demand for credit because of the diversification of funds from the securities market to the commodity market. Consequently a selling pressure developed which had the effect of damping down security prices (all shrot-term rates rose from their war-time levels) and thus making the maintenance of the cheap money policy extremely difficult. The Reserve Bank

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[4] For details, see Banking Companies Act, 1949.

[5] Supra, p.

continuously poured money in the economy through its open market purchase of securities and thereby sustained the inflationary pressures. The mechanical self-defeating open market operations of the Reserve Bank became more than apparent at the outbreak of the Korean War in June 1950 when the banks unloaded a large quantities of securities in the market. [6]

The Government adopted during this period various short-term measures along the Keynesian lines to stabilise the inflationary situation. But those measures proved to be ineffective because of the structural rigidities and built-in inflexibility of the economy. The failure of the measures also demonstrated the fact that the short-term problems of monetary stability in an under-developed country are intimately connected with the problems of long-term development of the economy. In the case of India the difficulties were further aggravated by the partition of the country and reemphasised the necessity of comprehensive planning as the only way to transform a backward and stagnant economy into a self-generating and self-sustaining one. Accordingly, the Government of India set up a Planning Commission to make an assessment of the resources of the country and to formulate a plan for the most effective and balanced utilization of the resources. The long-term economic development of India began with the commencement of the First Five-Year Plan in April 1951.

With the commencement of planned economic development of India the role of monetary policy needed to be clearly defined. The very acceptance of planning as an approach to economic policies originated from the failure of monetary policies as reliable instruments of economic progress. Even the strongest advocate of monetary policy never claimed it to be the only or the principal instrument of economic growth. With increasing trends of public policies towards growth and development rather

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[6] Supra, p. 128

than merely short-term equilibrium, the role of monetary policy was bound to be relegated to a subordinate position. This was accepted in principle by the authorities and the Planning Commission which unmistakably considered public investment, fiscal policy and physical controls as the major devices of economic development. But they gave a new province and wider interpretation to monetary policy, and it was the combined force of both fiscal and monetary policies which the Commission intended to apply in order to achieve the targets of public and private investment and to eliminate violent cyclisal fluctuations.

The Planning Commission fully realised both the power and limitations of monetary policy for securing the desired ends. It emphasised the dynamic Schumpeterian role of money, i.e. "credit creation somewhat in anticipation of the increase in production and the availability of genuine savings" was imperative, for "without this kind of initial push, the upward process may not start at all or may fail to gather momentum." [7] Again, it was stressed that the cost element in the supply of credit should not be allowed to become the final measuring rod because, "the proper discharge of its functions by the banking system will necessitate its operations more and more in the light of priorities for development indicated in the Plan and less and less in terms of returns on capital". [8] Such an approach marked a complete reorientation and a radical transformation of the role of monetary policy in India in the context of planning. However, inspite of these pious utterances monetary policy in India moved along the traditional lines of contraction and expansion in the crude form for the next five years, unrelated to the needs of a developing economy.

The new monetary policy which was announced in November 1951 introduced logic and consistency in the monetary management of the Reserve Bank in the place of old policy of drift and uncertainty. The Reserve Bank ended its

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[7] The First Five-Year Plan, p. 39.

[8] Ibid

mechanical self-defeating open market operations and relinquished the obligation of purchasing government securities from banks in the busy season. The Bank also introduced the bill market scheme to meet the seasonal requirements of the banks. These changes not only put open market operations of the Reserve Bank on a realistic basic but made the Bank rate effective in the organised sectors of the Indian money market and other rates began to move around the orbit of the Bank rate. Most of these changes were broadly directed towards introducing organisational and institutional changes for which there was a crying need. These changes also enhanced the power and the sway of central banking control. But, inspite of these commendable developments, the Reserve Bank pursued a mistaken policy of monetary deflation. The Bank failed to apply its monetary policy in a flexible manner or adjust it to the changing economic conditions. The continued recession and low level of investment, both public and private, during the first three years of the Plan were, to a considerable extent the result of the contractionist policy of the Reserve Bank itself.

After witnessing the harmful effects of a deflationary policy on investment, the Reserve Bank evolved a policy of "controlled expansion" during the first year of the Second Plan. [9] It was realised that a growing economy would require a continuous increase in money supply and bank credit, but as the development expenditures were potentially inflationary, owing to a lag between increased money incomes and the supply of available goods and services on which these incomes could be spent, the need for restraining undue monetary expansion became paramount. The Reserve Bank liberalised credit facilities under the bill market scheme, but imposed a series of qualitative credit measures, which, in conjunction with the quantitative methods of credit control aimed to regulate the cost, availability and direction of credit. As the inflationary forces gathered momentum towards the end of the Second Plan period

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[9] Report on Currency and Finance, 1956-57, p. 30-31.

the Reserve Bank put more emphasis on the control of credit and applied a direct quantitative method of credit control, viz. variable reserve ratios. All these measures of monetary policy were further strengthened by the imposition of ceilings on central banking accommodation and a system of a graded Bank rate. These developments marked the climax of twenty-five years of existence of the Reserve Bank, which, like a real master of the situation, applied various instruments of monetary policy in changing combinations and varying degrees of emphasis in pursuance of its policy of controlled expansion. Much of the success of monetary policy during the Second Plan period was due to the ingenuity of the Reserve Bank and for this it should be given credit. But one must not forget the powerful support to monetary policy coming from factors of a rather temporary and special character. [10]

The Reserve Bank of India has now acquired tremendous power, resources and prestige in the market. Central banking control of credit is the chief instrument of monetary policy and the Reserve Bank is very much alive and active to the changing credit conditions and willing to undertake bold new experiments in its monetary management. We have seen how monetary policy was used both extensively and intensively during the Second Five Year Plan and it is likely to be pursued with same vigor during successive Plans. However, inspite of these favourable developments in the sphere of monetary management of the Reserve Bank, central banking control in India is far from satisfactory. This is partly due to the weakness of the Indian banking system and partly to the fault of the Reserve Bank itself. Appropriate measures should be taken to end the present dualism in the Indian money market by bringing the important sector or the market, i.e. the indigenous bankers and money lenders within the orbit of central banking control. The unorganised sector of the Indian money market caters for more than 75 % of the needs of the rural po-

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10 The most notable of these was the U.S. Commodity Assistance under Public Law 480.

pulation and finances an equal percentage of the total internal trade. So long this vital and significant sector of the money market remains outside the scope of central banking control, monetary policy of the Reserve Bank is bound to have limited significance.

In view of the importance of this sector the Reserve Bank devised a scheme in 1937 [11] under which it was prepared to extend rediscountnng facilities to the shroffs provided they gave up their non-banking business, published their accounts and get those inspected by the Bank. But the shroffs were obtaining rediscounting facilities from the Imperial bank and other scheduled banks and they were in no mood to accept the conditions of the Reserve Bnnk. In 1941, however, the Bank made a final bid by enquiring of the Bombay Shroff's Association regarding the number of shroffs who would like to accept a modified scheme based on agreed proposals to give up non-banking business over a period of time. The shroffs suggested a period of five years to effect legal segregation of banking and non-banking business, and they also agreed to the publication and inspection of their books. But no assurance was, however, given by the shroff's Association as to the number of banks prepared to join the scheme and the Reserve Bank insisted on knowing this in advance, in fact made it a condition precedent for the necessary legislation for the scheme. Instead of opening its discount window to the indigenous banks as a basis for the future negociation, the Reserve Bank closed it completely and remained silent.

Time has come to prepare a new scheme for extending rediscounting facilities to the indigenous banks and bringing them within the circle of central banking control. The Shroff's have also expressed their willingness to forge a link with the Reserve Bank and to being their banking business within the general credit structure,[12] Under the circumstances, the Reserve

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11 Circular No. C.Cr.v427/30 G (10) 37

12 Presidential address by B.M.Chinai at the Golden Jubilee Celebrations of the Bombay Shroff's Association, January 1961.

Bank should initiate necessary legislation without delay and without insisting on knowing in advance as to the number of indigenous bankers willing to join its scheme. The proposed legislation should provide for the licensing of the money lenders and indigenous bankers. If necessary, the Reserve Bank should make a separate schedule under which shroffs may be linked with the Reserve Bank and the later may give full facilities to the former as it has been giving to the joint-stock banks. In the beginning, transactions may be restricted to banks doing banking business only, but an exception may be made in favour of commission agency business in order that a large number of bankers may be able to join the scheme. At first only a few will come forward, but the main point is to keep the discount window open to the indigenous bankers. The Reserve Bank should define the scope and conduct of the indigenous bankers and the facilities they would be entitled from it under the scheme. Steps along these lines slowly but surely lead to the integration of the two sectors of the Indian money market.

The Reserve Bank also should take appropriate steps in the direction of creating institutional and organisational basis for a healthy and active money market. The failure of the bill market scheme could largely be attributed to the structural deficiencies of the Indian money market. At the back of the failure lay the fact that the bill market scheme did not move beyond a bilateral agreement between the Reserve Bank and the buyers of those bills. The same could be said of the Treasury bills. Efforts were not directed towards the creation of a bill market in the sense and form in which it exists in London. No steps, for example, were taken for such familiar constitutents or their alternative to suit Indian conditions - as Discount Houses, Acceptance Houses, Market Syndicate, Bill brokers other than Government brokers etc. which form the core of the London bill market. Moreover, such requisite practice as concessional rates charged by banks in respect of advances against bills not followed. Such a provision was particularly necessary in India in view of the wide spread habit of cash credit. Absence of banking convention regarding

assets ratio and timely intervention of the Departmental funds etc. thwarted the growth of the bill market scheme.

The bill market scheme could and should be revived and made an integral part of the short term money market if the Reserve Bank takes appropriate measures in the creation of a proper institutional and organisational basis for it. In this connection only a part would have to be created anew, while the rest could be evolved out of the existing structure.[13] As for example, the Industrial Credit and Investment Corporation, established in 1955 and whose capital was subscribed by the Reserve Bank, scheduled banks and insurance companies and which was supposed to undertake underwriting business, a beginning could be made towards the creation acceptance House by using the ICIC as a nucleus. Similarly, the Managing Agency House, the most important financial institution in the private sector, next only to the banks, could be asked to form a syndicate or consortium like the syndicate of Discount houses in London, and brokers who deal in Government securities and arrange special funds for banks could take up the function of negociating bills. Steps along these lines would form a solid base towards the development of an active money market.

The Reserve Bank of India should make adequate provisions in order to extend the facilities of the bill market scheme to cover transactions in the unorganised sector of the Indian money market. Hundis are the principle credit instruments in this sector and it is estimated that funds of the order of Rs. 25 crores are employed in the Hundi business in Bombay alone. So far the Reserve Bank has taken little notice of hundi business and the official indifference is in no small measure responsible for the decline of hundi bazaar. The present hundi market constitute the nucleus of real bill market in India and by making funds available through rediscounting facility

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[13] J.D. Sethi, Problems of Monetary Policy in an Underdeveloped Country, p. 267.

this wing of the Indian money market should be fostered. Any realistic development of the bill market in India and the integration of the two sectors of money market would be impossible without the Reserve Bank's recognition of hundis as credit instruments and therefore eligible assets for rediscounting.

But there are some practical difficulties in dealing with hundis owing to different types of hundis. Some of them are written in vernacular and sometimes onerous conditions are attached to them. The organised hundi market, as is in existence in Bombay, is in the form of Multani hundis. The Reserve Bank Act should be suitably amended to include these hundis as rediscountable assets. The Bank should encourage standardization of other types of hundis and advice the shroffs who are doing their business by way of demand hundi should consider the possibility of introducing usance hundis of ninety days. The monetary authorities also consider the question of reducing stamp duties on such hundis.

However, because of the very nature of the hundi business and for their small amounts it is not advisable for the Reserve Bank to deal with them, but the bank should encourage hundi business through banks, preferably smaller ones. The Reserve Bank should place funds at the disposal of banks dealing with hundis through some arrangement like the Blanket Participation Agreement in the U.S.A. The Reserve Bank should ask the shroffs and their wealthy depositors to organise discount houses under its protection and should encourage the use of bankers acceptance. The Reserve Bank should also consider the possibility including bills of more than ninety days maturity as eligible assets. Measures along these lines would forster the development of an active and enlarged money market, which in turn would enhance central banks influence over the entire credit structure.

The main objective of monetary policy and central banking is to keep the economy upon even keel. Central banking institution is only a means, rather a secondary means to promote economic stability and growth. But when the economy

itself is inherently unbalanced and full of uncertainties the task of achieving monetary stability through the central banking operations becomes well neigh impossible. Both the first and the Second Five-year Plans of India have behave differently than they were originally envisaged. The basic fact is that it is not the economy which is controlled by the planners, but it is the planners who are in the grip of the economy. The same applies to the monetary authorities.

The experience of the first two plans also revealed that there are too many imponderables and uncertainties in the Indian planning. What is needed is some rethinking on the economy by the planners, because a lack of understanding of the nature of the economy has created a false sense of optimism and conflicts in the Indian planning. This has been further deepened by the absence of clearly defined present needs of the country and her people and the future goals of planning and the means to achieve those not only in money terms but in terms of real resources.

India is basically an agricultural country but the planners wanted to achieve industrial revolution without first accomplishing the oldest of man's revolution, that is, agricultural revolution. Unusually, good harvests for three years during the First Five-Year Plan created a false sense of optimism regarding self-sufficiency in food and agricultural products, and the planners set themselves to lay the foundations of an industrialised society based on heavy industries. But good harvests were not because of planning rather inspite of it because those were depended on the uncertain circumstances of favourable monsoon. The failure of monsoon and consequent shortages of food and agricultural products became the limiting factors of economic development of India during the subsequent years. Indian agriculture does not feed her cultivators enough, much less could it support the greatly enlarged industrial and urban population upon which modern India or any industrial society must rest. Such shortages became more and more acute with the ever increasing population of India and the consequent heavy reliance on the Commodity Assistance from the United

States under the P.L. 480 Agreements underlined the fundamental conflict of objectives in Indian planning.

The difficutltiesof financing the plans revealed another unresolved dilemma of economic development of India through planning. If a large portion of development finance came from foreign assistance, which is at best uncertain and deficit financing, which is potentially inflationary, the future economic development becomes precarious. The economy is now faced with the paradox of the "take off stage", and a conflict has emerged between organic self-sustaining growth and its artificial implantation through foreign assistance and deficit financing at home. The present optimism is that the take off stage could be attained by the end of the Fourth Five Year Plan. It is possible that monetary aspects of the take off stage may superficially appear to have been solved and yet it would be far from the reality.

Price line has obviously not been held and it has exerted a great pressure on the monetary authorities and has forced the Reserve Bank of India to take ever more drastic measures. It is now universally recognised that monetary policy can certainly be used but not so vigorously without defeating its purpose. It is more so in a country like India where currency exceeds deposits, which fact "sets limit on the extent to which monetary policy of the central banking authority can make itself felt". [14] Strong monetary measures are bound to affect investment in the private sector, and if investment is discouraged then the economy will be back at the vicious circle of poverty and low level of investment, which the planners are attempting to break through.

Regarding price policy the authorities have presented conflicting attitudes and policies since 1951, and the absence of strict control and rationing of food and other essentials of life gave a free hand to the speculators and hoarders. Food remains a perennial problem of economic development of India.

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[14] Reserve Bank Bulletin, November 1957.

Some day the extra ordinary imports would have to end, and if they do not continue to serve us we shall be back at the old question, viz. can we do without internal control over supply and rationing. The answer to this question is obviously in the negative. Recurrent crises of food and other essentials of life brought this point home and the authorities were forced to take measures along these lines.

Diminishing returns have set in the Indian tax system for the lack of necessary organisation to bring rising rational income and taxation into some reasonable relationship. The ratio of tax revenue to national income remained the same despite the increase in the marginal rate of taxation. Borrowing programmes are satisfactory only to a certain extent and the proportion of public debt to income is still very low. It is less than 25 % of the national income, whereas in the advanced countries it is as high as 200 to 300 %. Contributions of the public sector towards development finance have been disappointing. If the planning with a large share of public investment is to have any logic the surpluses from the State undertakings should proportionally increase. But the performance during the Second and Third plans have been poor. Consequently, a greater pressure has been exerted on the demand for loans from abroad and deficit financing at them, both of which, if carried beyond certain limits, contradicts the requirements of take-off stage. Under these circumstances, even if the break through the low level equilibrium trap is possible in the near future there is no certainty that the growth will be self-sustaining or will work by the automatic feed back process.

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CURRICULUM VITAE

I, Nur Alam Mollah, of Calcutta, was born on February 28, 1935, in Burdwan, West Bengal. My parents were the late Jonab Abdul Bari Mollah, landowner and businessman, and his wife Kulsuma Mollah, née Begum.

After my primary schooling at Kurkaba, I entered the Galsi High English School and matriculated in 1951. Then I attended lectures at the Presidency College and the Scottish Church College, Calcutta, and obtained the degree of B.A. (Honours) in Economics and Political Science from the University of Calcutta in 1956. The same year I entered the London School of Economics and Political Science, and obtained the degree of B.Sc. (Econ.) with Honours in Money and Banking from the University of London in 1959. During my specialization in Money and Banking, I studied under Prof. R.S. Sayers, Prof. J.S.G. Wilson and Mr. A.C.L. Day.

Thereafter I was engaged in teaching at schools in London under the London County Council for some time. Then I joined a market research organization in London as a research executive. At the same time I was engaged in research studies in the University of London as an external student, and published some articles on current economic problems.

In 1963 I entered the University of Basel and continued my research studies under the personal supervision and scholarly guidance of Prof. Dr. E. Salin. In the University of Basel I attended the following lectures: Professor Salin: The Economic Development of Underdeveloped Countries, The History of Economic Thought and Sociology; Bombach: Keynesian Economics, Income Distribution and Monetary Economics; Erbe: The Banking System and International Monetary Economics; Popitz: Industrial Sociology and Social Customs; Annaheim: Economic Geography.

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